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Corporate Law and the Longterm Shareholder Model of Corporate Governance

John H. Matheson

Brent A. Olson

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and Brent A. Olson**

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* Professor of Law, University of Minnesota Law School. Of Counsel, Kaplan, Strangis & Kaplan, PA.

** J.D., University of Minnesota, 1991; M.B.A., University of Minnesota, expected 1992.

INTRODUCTION

> The key to effective [corporate] accountability today appears to be the existence of a class of "permanent" owners, holding approximately one-quarter of the outstanding equity, who have an incentive to monitor the operations of the corporation. This is essentially the system in Germany, Britain, and Japan. . . . In the United States, encouraging a pattern of domestic institutional ownership will be a way of ensuring the continuance of effective governance. The challenge, then, for the United States is to identify its "permanent" shareholder institutions and to ensure that they have the *incentive* and *ability* to perform the monitoring function.[1]

As recently as a few years ago, the ability and desire of corporate shareholders to mount a challenge over corporate governance[2] seemed suspect. After all, shareholders were considered to be passive, impotent, and unconcerned. A shareholder revolution, however, is occurring, highlighted by the ascendancy of the institutional investor.[3] This development, combined with the current anti-shareholder corporate governance trend, renders obsolete much of contemporary corporate

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1. ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 243-44 (1991) (emphasis added). Monks and Minow believe that pension funds supply the necessary core of "permanent" shareholders. *Id.* at 262.

2. As used herein, "corporate governance" defines the process by which the balance of power between a corporation's shareholders and nonshareholders is allocated. Nonshareholders include the corporation's board of directors, officers, creditors, suppliers, and customers. The current framework of corporate governance is defined through state-enacted corporate codes, case law, and customized corporation-specific provisions such as articles of incorporation and bylaws.

3. Monks and Minow, acknowledging this new regime, explain:

> [W]e are now witnessing the reagglomeration of ownership of the largest corporations, so that long-term shareholders are well on the way to majority ownership of America's companies. They are, of course, the institutional shareholders, who invest collections of individuals' assets through pension funds, trusts, insurance companies, and other entities.

MONKS & MINOW, *supra* note 1, at 18.

"Notwithstanding major differences among them, institutional investors as a group, have vastly expanded their economic sphere of influence in a number of important ways. Moreover, while they may be diverse, a high concentration of economic power resides among a relatively small and extraordinarily stable group of institutions." Carolyn K. Brancato, The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Research at the Columbia Institutional Investor Project, Presented at The Conference on the Fiduciary Responsibilities of Institutional Investors, Leonard J. Stern School of Business, New York University (June 14, 1990), *in* INSTITUTIONAL INVESTORS: PASSIVE FIDUCIARIES TO ACTIVIST OWNERS 406, 406-07 (PLI Corp. Law & Practice Course Handbook Series No. 704, 1990) [hereinafter INSTITUTIONAL INVESTORS].

law doctrine and practice. As a result, corporate law is in flux and turmoil.

"[A]n extraordinary ferment of activity in the field of corporate governance"[4] has resulted, including the proliferation of state-adopted and corporation-imposed antitakeover mechanisms such as the poison pill,[5] increased involvement by the Securities and Exchange Commission (SEC), and intense criticism by institutional investors of current corporate governance structures and mechanisms. Such intense controversy surrounding corporate governance issues appears inevitable given the far-reaching economic and social impact of the modern corporation.[6] The stakes are enormous.[7]

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4. Roswell B. Perkins, *The President's Letter*, 4 A.L.I. REP. 1 (1982), *quoted in* Melvin A. Eisenberg, *An Introduction to the American Law Institute's Corporate Governance Project*, 52 GEO. WASH. L. REV. 495, 496 (1984).

5. Poison pills or shareholder rights plans typically are stock warrants or rights which allow the holder to buy a suitor's stock at low prices ("flip-overs") or to sell target stock to the target itself ("flip-ins"). *See, e.g.*, P. John Kozyris, *Corporate Takeovers at the Jurisdictional Crossroads: Preserving State Authority Over Internal Affairs While Protecting the Transferability of Interstate Stock Through Federal Law*, 36 UCLA L. REV. 1109, 1156 (1989). The Investor Responsibility Research Center, an independent non-profit research group, found that 51% of large American companies were armored with poison pills as of August, 1990. *Majority of Large U.S. Corporations Have Adopted Poison Pills, IRRC Finds*, [July-Dec.] Sec. Reg. & L. Rep. (BNA) No. 47, at 1659 (Nov. 30, 1990); *see also* Kozyris, *supra*, at 1125 n.59 ("If the recent trends continue, virtually all major corporations will be transformed into fortresses in the near future.").

6. "Today, . . . the corporation is the dominant form of business organization[,] . . . account[ing] for about 89 percent of business receipts. . . . [O]verall, the business corporation is the principal form for carrying out business activities in this country." ROBERT C. CLARK, CORPORATE LAW § 1.1, at 1-2 (1986). Few governance issues affect society as broadly and intensely as corporate takeovers. Thus, "[n]o current corporate issue has attracted more attention from legal and economic scholars than takeover defensive moves by corporate managers." Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 72 (1989). For commentary probing major economic concerns over takeover activity and antitakeover devices, see Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter Easterbrook & Fischel, *Corporate Control Transactions*]; Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter Easterbrook & Fischel, *The Proper Role*]; Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981) [hereinafter Easterbrook & Fischel, *Takeover Bids*]; Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982); Ronald J. Gilson, *A Structural Approach to Corporations: The Case*

The current corporate governance framework does not adequately address the evolution of the nature and role of modern institutional investors. Accompanying institutional investors' growth and concentration of share ownership[8] is their desire and ability to participate meaningfully in governance issues.[9] Moreover, at no time has the need for shareholder activism been more acute; the marked downturn in takeovers[10] this dec-

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Against Defensive Tactics in Tender Offers, 33 STAN. L. REV. 819 (1981) [hereinafter Gilson, *A Structural Approach*]; Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987) [hereinafter Lipton, *Corporate Governance*]; Martin Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook & Fischel*, 55 N.Y.U. L. REV. 1231 (1980) [hereinafter Lipton, *Target's Boardroom*]; John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425 (1991); Dale A. Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53 (1985); Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229 (1986); *see also* Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1434-44 (1964) (explaining how shareholders may react to tender bids, mergers, and proxy fights).

7. *See* Martin Lipton, *A Proposal For a New System of Corporate Governance: Quinquennial Election of Directors*, (June 11, 1990), *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 61, 63 ("The stakes are large. Indeed, I believe that the health and vitality of our entire economy is at risk.").

8. Institutional investors' ownership of publicly held corporations has grown explosively in recent years. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 827-29 (1992); Matheson & Olson, *supra* note 6, at 1477-78; *see also* Richard H. Koppes & Kayla J. Gillan, *The Shareholder Advisory Committee*, DIRECTORS & BOARDS, Spring 1991, at 29, 29-30 ("The reality is that institutional investors are growing in size and will continue to control larger and larger blocks of outstanding equity [resulting] in a shareholder group that is profoundly different . . . .").

9. Institutional Voting Research Service Client Advisory Letter (July 1990) [hereinafter July 1990 Client Advisory Letter], *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 33, 34 ("Concentrated ownership has given rise to a new form of corporate governance whose ultimate shape and structure has yet to be fully defined . . . ."); James A. White, *Shareholder-Rights Movement Sways a Number of Big Companies*, WALL ST. J., Apr. 4, 1991, at C1 ("The solid wall of corporate opposition to shareholder-rights proxy measures is beginning to crumble, as big pension funds win concessions from an unprecedented number of large companies.").

10. No governance issue has received more attention than the impact of takeovers and antitakeover weaponry upon shareholders and nonshareholders. For commentary on this issue, see Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635 (1988); Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986); John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders, and Bust-ups*, 1988 WIS. L. REV. 435 [hereinafter Coffee, *Takeover Re-*

ade[11] eliminates the potential disciplinary force that the threat of takeovers can have upon management.[12] Although commentators have struggled to keep pace with institutional shareholder activism[13] amid this changing corporate landscape,[14]

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form]; Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862 (1989) [hereinafter Johnson & Millon, *Williams Act*]; Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989) [hereinafter Johnson & Millon, *Missing the Point*]; Donald C. Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213 (1977); Jonathan R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467; Matheson & Olson, *supra* note 6; Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

11. *See Merger, Acquisition Activity Fell 18% In First Quarter, Hitting an 11-Year Low*, WALL ST. J., Apr. 16, 1991, at A2 ("Merger and acquisition activity plummeted to an 11-year low in the first quarter [of 1991], with the number of transactions off 18% from a year earlier . . . continuing the decline that appeared in 1990 when potential deals fell 12% from 1989.").

12. Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb. 1990, at 96, 100 ("It is impossible to overstate how deeply the market for corporate control has changed the attitudes and practices of U.S. managers. . . . [That market] represents the most effective check on management autonomy ever devised."); White, *supra* note 9, at C1 (quoting Nell Minow, president of Institutional Shareholder Services, Inc., a Washington proxy consultant who explains: "This year['s shareholder activism] is unusual because the takeover activity that fueled momentum for [corporate governance] proposals in other years hasn't been there.").

Commentators discount the effectiveness of hostile takeovers to discipline corporate management for varying reasons. *Compare* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN L. REV. 863, 870-71 (1991) ("Given the contribution of hostile takeovers to portfolio values during the 1980s, institutional investors were quite right to target defensive tactics in their initial foray into the corporate governance debate. . . . [Nevertheless, t]he hostile takeover has proved to be an expensive and inexact monitoring device . . . .") *with* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 198 (1991) (asserting that "the hostile takeover is not a particularly effective or efficient means of motivating or disciplining managers").

13. Scholars discussing the nature and role of institutional shareholders amid the current corporate law landscape include Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988); Matheson & Olson, *supra* note 6; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); A.A. Sommer, *Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. CIN. L. REV. 357 (1990).

14. Several scholars have attempted to describe the nature and character of the current governance regime. *See, e.g.*, Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989); Victor Brudney, *Corporate Governance, Agency Costs,*

none have proffered a model procedural governance framework as proposed in this Article.

Corporate law has developed dialectically in four stages. In the current "insulated managerialism" stage of corporate law,[15] institutional shareholders lack an incentive to invest in a corporation for the long term. They currently lack the opportunity to offer meaningful guidance on fundamental corporate affairs and major longterm financial strategies.[16] Piecemeal reform efforts cannot address the core weakness in the current frame-

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and the Rhetoric of Contract, 85 COLUM. L. REV. 1403 (1985); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle & Means*, 22 U. MICH. J.L. REF. 19 (1988); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881; Melvin A. Eisenberg, *The Structure of Corporate Law*, 89 COLUM. L. REV. 1461 (1989); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982) [hereinafter Fischel, *The Corporate Governance Movement*]; Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982) [hereinafter Fischel, *The "Race to the Bottom"*]; Lipton, *Target's Boardroom*, *supra* note 6; Lipton & Rosenblum, *supra* note 12; Donald E. Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511 (1984); Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reaction to "Changes" in Corporate Law*, 75 CAL. L. REV. 551 (1987); Elliott J. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1 (1984).

As to the nature and function of corporate law generally, see AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Proposed Final Draft) (March 31, 1992) [hereinafter Proposed Final Draft]; CLARK, *supra* note 6; CORPORATIONS AND SOCIETY: POWER AND RESPONSIBILITY (Warren J. Samuels & Arthur S. Miller eds., 1987); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990).

15. *See infra* part I.D.

16. [O]wning stock and not being able to assert your ownership rights is like owning a piece of land over which you have little control. If you can't walk on it, garden it, put a fence around it, or build on it, it isn't worth much. If American corporations are owned by stockholders who can't assert their ownership rights eventually the ownership may not be worth much either. . . . I believe that a number of steps must be taken to reinforce the rights of shareholders or they will be completely disenfranchised.

> First, institutions must act like the permanent owners of the businesses in which they [invest]. . . .
>
> Second, institutional investors should put pressure on directors to be more responsive to shareholder concerns about longterm strategies and the productive use of corporate assets. . . .

Letter from Edward C. Johnson to Fidelity shareholders (Apr. 3, 1990), *in* MONKS & MINOW, *supra* note 1, at 204-05.

work of corporate governance—that modern institutional shareholders lack both the incentives and legal base to invest in a corporation for the long term.[17]

This Article proposes to harness fundamental principles of corporate governance[18] to develop an innovative governance framework responsive to the evolving nature of modern institutional shareholders and boards of directors. The focus of this

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17. *See, e.g.,* Black, supra note 13, at 525. Black explains:

> The way to see if shareholder voting can matter is to change the legal rules that obstruct individual and collective shareholder action . . . . Piecemeal change, though, such as recent proposals to reform the proxy rules, has only limited promise. There are many obstacles to shareholder voice, and their burden is cumulative. Changing *only* the proxy rules won't have dramatic results.

Id.; *see also* Lipton & Rosenblum, *supra* note 12, at 203, 213 ("Our rules of corporate governance require the sort of fundamental reform that will align the interests of all corporate constituents toward the long term. . . . Any reform . . . must be part of a larger effort to reorient stockholders toward a long-term perspective."); Weiss, *supra* note 14, at 3 (arguing that reform "must constitute a comprehensive and internally consistent set of rules for corporate governance").

18. Professor Elliott J. Weiss has enumerated seven widely accepted propositions which "serve as premises on which a system of rules for the governance of publicly held corporations should be based":

> [1]—The corporate form of organization provides suppliers of capital ("shareholders") and suppliers of entrepreneurial skills ("managers") with a potentially efficient vehicle for pursuing economic gain.
> [2]—Shareholders and managers have a joint interest in enhancing corporate profits. . . .
> [3]—Despite shareholders' and managers' shared interest in enhancing corporate profits, managers inevitably will make some decisions that result in losses. . . .
> [4]—[M]anagers' interests [sometimes] conflict with those of shareholders and some managers will choose to impose "agency costs" on their corporations. . . .
> [5]—Shareholders can take a number of actions to protect themselves against the impact of agency costs [including portfolio diversification, discounting or selling their stock, or] voic[ing] their dissatisfaction by voting to elect new managers or by suing to remedy breaches of fiduciary duty. Because exit is cheap and "voice" is often expensive, ineffective, or both, most shareholders will favor exit.
> [6]—The "voice" mechanisms remain significant in two contexts. First, new shareholders prepared to buy a substantial portion of a corporation's stock or existing shareholders prepared to finance a proxy contest can use shareholder voting rights to replace inept or self-aggrandizing managers. Second, [shareholders] can use derivative suits to police managers' breaches of their fiduciary duties. . . .
> [7]—Outside, or nonmanagement, directors have the potential to monitor managers' performance more efficiently than shareholders . . . . Outside directors are not always effective monitors, though, and there is little evidence that corporations with boards consisting primarily of outside directors are more profitable or more highly valued by investors than other corporations.

Weiss, *supra* note 14, at 3-5 (footnotes omitted).

model framework is the *process* by which corporate governance powers are allocated. Rather than setting out substantive rules fixing the respective duties and powers of shareholders and nonshareholders, the proposed model establishes a *process* by which governance issues are resolved.

Such a "process approach" offers many advantages. First, a procedural framework can remain viable amid a dynamic corporate law landscape. Second, although most institutional investors cannot monitor the hundreds of companies within their portfolio, they can monitor particularly important events and issues in those companies. Indeed, focusing upon significant issues common to all corporations obviates the need for longterm shareholders to engage in firm-specific monitoring. The increased economies of scale afforded by this procedural focus will fuel longterm shareholders' incentives to improve underlying corporate performance and profitability.[19] The proposed procedural governance framework ensures that the directors will seek input from longterm shareholders whenever fundamental changes in the corporation's governance regime are proposed. Third, a procedural corporate law regime may be the inevitable result of the forces currently shaping corporate law. In particular, such a structure is the logical result of the "nexus of contracts" perspective of corporate law.[20]

Process-oriented reform should squarely address the circumstances under which shareholders should or must be allowed to guide directors' or managers' business judgment. Longterm shareholders must be allowed to do so when either or both of two factors exist: when conflicts of interest between shareholders and nonshareholders substantially blur a board's ability to determine an appropriate course of action objectively and efficiently, or when the decision facing a director will have such an impact upon the shareholders' financial investment that *shareholders* possess significant incentives to determine the course that will maximize longterm shareholder/corporate value.

Shareholders' procedural involvement may appear through several mechanisms, including shareholder voting and shareholder advisory committees. Fully implemented, this proposal would enable the board to perform the function it is best suited

19. *See* Black, *supra* note 8, at 834-38 (noting that "shareholders have stronger incentives to take an active interest on issues for which scale economies [exist]").

20. *See infra* part III.A. (discussing the "process approach").

to perform: to be an effective central mediator between longterm *shareholders* and longterm *stakeholders*. Under the proposal, the board would also seek the advice of major longterm shareholders on significant financial matters, in addition to seeking the counsel already provided by management and longterm stakeholders.

The longterm economic efficiency that this model generates should be self-propagating. Sophisticated shareholders will invest only in those corporations with responsive management. This fosters cooperation. Corporate management will be forced to consider the desires of major longterm shareholders.[21] Corporations that acknowledge major longterm shareholders' governance desires will have share prices that reflect greater shareholder satisfaction, and ultimately will be able to attract the patient capital essential for longterm success.[22]

This Article suggests a process by which longterm shareholders may meaningfully influence corporate governance. Part I describes the development of the current governance regime as framed by practices, legislation, and case law. Corporate law has evolved in four stages, from shareholder primacy to managerial capitalism, and then from management monitoring to the current situation, flourishing insulated managerialism. Consequently, the current governance framework is inconsistent with the ascendancy of the institutional investor. Part II describes the potency of the escalating conflict between shareholders and nonshareholders and examines current reform proposals. This Part argues that institutional investors lack an effective means of involvement in governance issues and thereby lack the incentive to view their holdings as longterm investments.

Accordingly, Part III of this Article sets out a model framework of corporate governance based on the assimilation of the institutional investor as the quintessential longterm shareholder. This part proposes recognizing the role and right of the "longterm shareholder" as a means toward reducing this shareholder/nonshareholder tension. The purpose is to promote co-

21. *See* Institutional Voting Research Service Client Advisory Letter (May 1990) [hereinafter May 1990 Client Advisory Letter], *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 25, 25 (asserting that "shareholders are developing a memory, and will in the future penalize boards who have in the past acted in a way that ignores shareholder preferences").

22. *See* Howard D. Sherman, Special Report: The 1990 Proxy Season (Institutional Shareholder Serv., Inc., Aug. 10, 1990), *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 297, 300.

operation, thereby easing the conflicts between shareholders and nonshareholders that have escalated with the rise of the institutional investor, and to provide a process by which shareholder interests are represented effectively. Moreover, since meaningful reform must ultimately be ground in specific statutory language, this Article proposes model statutory provisions that are consistent with the role of the longterm shareholder in corporate governance. Part IV of the Article explores the nature and destiny of the "longterm shareholder" governance regime.

I. THE DIALECTICAL DEVELOPMENT OF CORPORATE GOVERNANCE

The relationship between shareholders and nonshareholders in the operation of the modern public corporation appears to have a dialectical character: as the power of one expands, the power of the other diminishes; the strength of the one often causes the other to react to expand its power. Thus, commentators often view shareholder and nonshareholder interests as opposing and mutually exclusive. Modern shareholders, they argue, typically seek short-term profit while nonshareholders typically seek longterm protection.[23] The American Law Institute Corporate Governance Project describes the dialectical nature of tensions between shareholders and one nonshareholder group, management, as endemic to corporate governance:

> The challenge for corporate law is to facilitate the development of a corporate structure that allows management the discretion to utilize its expertise on behalf of shareholders, but at the same time establish safeguards in situations in which management might utilize that discretion to favor itself at the expense of shareholders.[24]

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23. *See, e.g.,* Lipton & Rosenblum, *supra* note 12, at 214-15.

24. Proposed Final Draft, *supra* note 14, introductory note to part VI, at 519; *see also id.* introductory note to parts III & III-A, at 99 (noting that there are "two highly important social needs regarding [publicly held] corporations[:] the need to permit a corporation to be highly flexible in structuring its operational management [and] the need for processes that ensure managerial accountability to shareholders"). Building upon this dichotomy, Professor Lyman Johnson asserts that the function of corporate law

> should [be to] confer a sufficiently wide berth of discretion to enable management to operate creatively and flexibly but should not be so broad that management can subvert the ultimate objective of shareholder welfare. These dual strands of management discretion and shareholder welfare are in constant tension, and each is poised on any given issue to check, if not negate and overwhelm, the other.

Johnson, *supra* note 14, at 880 (footnote omitted). Dean Robert Clark has also argued that

The tensions seemingly inherent in the modern public corporation have more or less evolved dialectically over time.[25]

> the role or function of the manager is to act on behalf of other persons' interests. Yet power corrupts. It can be turned to [a manager's] personal use . . . in ways that hurt the other persons having claims on the organization. The problem, then, is how to keep managers accountable to their other-directed duties while nonetheless allowing them great discretionary power over appropriate matters. This is the major problem dealt with by corporate law.

CLARK, *supra* note 6, § 1.5, at 33-34.

25. Although we do not attempt to describe the dialectical development of corporate law in philosophical terms, we recognize that philosophical principles of the "dialectic" have fueled efforts to describe the nature and evolution of social and economic phenomenon. Telescoping our general proposition beyond the corporate law domain, we suggest that whenever the relation between two classes or categories of individuals or entities has an intrinsically dialectical character, the evolution of their relationship shall proceed dialectically. Put differently, the nature of a thing (i.e., a dialectical relationship between two forces) compels the destiny of a thing (i.e., a dialectical progression and expression of those forces).

The proposition that certain social phenomenon evolve dialectically has been most forcefully articulated by the philosophers G.W.F. Hegel and Karl Marx. *See generally* Joseph McCarney, Hegel, Marx, and Dialectic, *in* HEGEL AND MODERN PHILOSOPHY 161 (David Lamb ed., 1987). Together, Hegel and Marx have established the significance of the dialectic for social science inquiry:

> The concept's moving principle, which alike engenders and dissolves the particularizations of the universal, I call "dialectic" . . . . The . . . dialectic of the concept consists not simply in producing the determination as a contrary and a restriction, but in producing and seizing upon the positive content and outcome of the determination, because it is this which makes it solely a development and an immanent progress. Moreover, this dialectic is not an activity of subjective thinking applied to some matter externally, but is rather the matter's very soul putting forth its branches and fruit organically. This development of the Idea is the proper activity of its rationality, and thinking, as something subjective, merely looks on at it without for its part adding to it any ingredient of its own. To consider a thing rationally means not to bring reason to bear on the object from the outside and so to tamper with it, but to find that the object is rational on its own account; here it is mind in its freedom, the culmination of self-conscious reason, which gives itself actuality and engenders itself as an existing world.

G.W.F. HEGEL, HEGEL'S PHILOSOPHY OF RIGHT 34-35 (T.M. Knox trans., Oxford University 1952) (1821).

Marx credits Hegel for pioneering the concept of the dialectic. Hegel's *Phenomenology of Mind* is a pivotal work for the Hegel-Marx nexus: it is for Marx "the true point of origin and the secret of the Hegelian philosophy." KARL MARX, ECONOMIC AND PHILOSOPHIC MANUSCRIPTS OF 1844, at 146 (1961). Marx argues that Hegel's dialectic "in its rational form" is "revolutionary." KARL MARX, 1 CAPITAL 103 (Penguin Books 1976) (1886).

Class conflict is the focus of Marx's dialectic. Marx's subject for dialectical inquiry (his "subjective" dialectic) is the social class, and in Marx's version of the phenomenological dialectic, the opposition of ruling ideas conflict and are refuted by reason. The primary "objective" dialectical opposition for Marx

This evolution has occurred in four stages.[26] The power struggle between shareholders and nonshareholders is the fuel propelling this dialectical evolution.[27]

In the first stage, marking the early years of modern corporate law, shareholder primacy was the norm. Shareholders had the right and power to control the operation of the corporation. As corporations grew and capital markets expanded, shareholders typically became more passive, relying on corporate management to run the business in the best interests of shareholders. As the gulf between shareholders and other corporate constituencies (including management) widened, corporate theorists proposed that management be monitored to

is that of labor and capital. This tension derives from a network of antagonistic class relationships which express themselves in opposing beliefs, purposes, and practices. For Marx, "the conflict of the classes can only be transcended by a transition to a new age if the historical process becomes conscious for . . . the proletariat." McCarney, *supra*, at 175.

Hegel and Marx believed that the historical evolution of dialectical tensions is a rational process. "[T]he only thought which philosophy brings with it is the simple idea of *reason*—the idea that reason governs the world, and that world history is therefore a rational process." G.W.F. HEGEL, LECTURES ON THE PHILOSOPHY OF WORLD HISTORY 27 (H.B. Nisbet trans., Cambridge University Press 1975) (1830) (emphasis added). Marx views the historical development of the social economy as the dialectical progression of forces and relations of production.

> At a certain stage of their development, the material forces of production in society come in conflict with the existing relations of production . . . . From forms of development of the forces of production these relations turn into their fetters. Then comes the period of social revolution.

KARL MARX, A CONTRIBUTION TO THE CRITIQUE OF POLITICAL ECONOMY 12 (N.I. Stone, Trans., Int'l Lib. Pub. Co., 1904) (1859). In this way, a bourgeois revolution catalyzed the transition from feudalism to capitalism; the replacement of capitalism by socialism would in turn result from a proletarian revolution.

We suggest that corporate law has more or less proceeded in dialectical stages. The seeds of this dialectical progression take objective foothold in the ownership/control dichotomy intrinsic to the corporate form. As one strand of the shareholder/manager dialectic expands its power, the other reacts to further entrench its power. The development of corporate governance has mirrored this intrinsic dialectical tension. The subjective manifestation of this dialectical tension is discussed in the remainder of Part I.

26. *Cf.* Robert C. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Trustees*, 94 HARV. L. REV. 561, 562-67 (1981) (suggesting that the history of capitalism embodies four stages: the age of the entrepreneur, the age of the professional business manager, the age of the portfolio manager, and the age of the savings planner).

27. Unlike the evolution of capitalism as depicted by Dean Robert Clark, *see supra* note 26, the evolution of corporate law has *not* been motivated by efficiency advantages; rather, the essence of the evolution has been the power struggle resulting from the shareholder/nonshareholder duality.

secure shareholders' interests. Legal monitoring devices, such as the independent director, were proposed and often adopted. The market for corporate control also evolved as a potent monitoring device. In response, nonshareholders aggressively developed protective mechanisms, culminating in the insulated managerialism of the current period.

A fifth stage of corporate development appears inevitable: the "longterm shareholder" stage. As shall become apparent, the longterm shareholder stage is a synthesis of several aspects of corporate development. It reconciles *shareholder* welfare on the one hand with *longterm* corporate welfare on the other. This longterm shareholder stage of corporate law harnesses the incentives of shareholders seeking to maximize their longterm wealth while collaterally advancing the longterm interests of nonshareholders and society.

A. THE SHAREHOLDER PRIMACY NORM

Despite the fundamental importance of defining the goals of corporate law, no corporate code attempts to address its purpose or function.[28] Recent scholarship on corporate governance demonstrates how governance goals are ill-defined.[29] Perhaps the fundamental goal of corporate law is so theoretically and historically obvious that it need not be explicated:[30] the goal is to maximize corporate—and thus shareholder—welfare.[31] At

28. *See* Schwartz, *supra* note 14, at 523 (stating that "corporate statutes . . . do not specify the purpose of the corporation"); Johnson, *supra* note 14, at 874 (asserting that "not a single corporate statute explicitly addresses the purpose of corporate activity"). Still, many business corporation statutes and the Revised Model Business Corporation Act define "corporation" to mean a corporation for profit. *See, e.g.*, N.Y. BUS. CORP. LAW § 102(a)(4) (McKinney 1986); REVISED MODEL BUSINESS CORP. ACT § 1.404 (1984).

29. Lipton & Rosenblum, *supra* note 12, at 187 ("In much of the recent academic literature on corporate governance, . . . the goals are either ill-defined or assumed without examination.").

30. "Every business manager 'knows' what corporations are all about—corporations make money from their products or services . . . ." Schwartz, *supra* note 14, at 514; *see also* Johnson, *supra* note 14, at 877-78 (arguing that "most persons in this country probably would be astounded to hear that maximization of shareholder wealth is the *raison d'etre* of corporate existence, yet the corporate doctrine takes that focus for granted").

31. More likely, legislators prefer to defer to scholars on the resolution of the knotty question of the meaning of corporate law. Although many possible goals of corporate endeavors have emerged, maximizing shareholder profits (with various exceptions, such as charitable donations) is the most established:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in

least this is the notion with which the law of corporations and the principles of corporate governance began.

The traditional shareholder primacy model of the corporation derives from the concept that the shareholders are the owners of the corporation and, as such, are entitled to control it, determine its fundamental policies, and decide whether to make fundamental shifts in corporate policy and practice. This system of corporate governance developed its essential attributes when "owners managed and managers owned."[32] There were few institutional investors and the shares of most corporations were owned by individual investors who were typically founders or local investors.[33] Other potential corporate constituencies took their place after and only to the extent the shareholders determined, by contract or conscience, to be so bound.

The viability of this model derives from economic common sense. Only shareholders have strong incentives to maximize profits,[34] thereby promoting economic efficiency.[35]

> the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes. . . . [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others . . . .

Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

Other goals of corporate law include maximizing longterm corporate welfare, maximizing the interests of the corporation and its shareholders, various economic goals, and various political goals (where the law should compel the corporation to pursue social goals that benefit society). *See* Schwartz, *supra* note 14, at 524-26. For a description of the "political model" of the corporation, see Melvin A. Eisenberg, *Corporate Legitimacy, Conduct, and Governance—Two Models of the Corporation*, 17 CREIGHTON L. REV. 1, 3 (1983).

32. ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 9-10 (1977).

33. *See* Lipton, *supra* note 7, at 64.

34. Because of the separation of ownership and control in modern corporations, management does not have the incentive to exert itself beyond the degree needed to "maintain a reasonably satisfied group of stockholders." ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 301 (rev. ed. 1967). Shareholders, however, are not similarly constrained. *Id.* at 299-302.

35. *See* CLARK, *supra* note 6, § 9.5, at 389. Clark has explained:

> From an economic point of view, there is a strong argument that the power to control a business firm's activities should reside in those who have the right to the firm's residual earnings . . . . The intuition behind this argument is that giving control to the residual claimants will place the power to *monitor* the performance of participants in the firm and the power to control shirking, waste, and so forth in the hands of those who have the best *incentive* to use the power.

Id. (emphasis added); *see also* Armen A. Alchian & Harold Demsetz, *Produc-*

The shareholder vote traditionally has been seen as an important mechanism for shareholder control over corporate decisions.[36] Shareholders vote to elect and remove directors.[37] The board in turn designates officers to act as agents of the corporation.[38] In addition, fundamental corporate transactions require shareholder approval. For example, shareholders normally must vote on mergers,[39] dissolutions,[40] or sales of substantially all of a corporation's assets.[41] Within this model, however, the board is presumed to act as a surrogate for and in the interests of the shareholders.

Justifications given for shareholders' primary voice in the governance of corporate affairs distill to one concept: Shareholders are well-suited to guide and discipline directors and managers. Shareholder guidance is the focal point for two reasons.

First, directors need guidance relating to corporate matters that raise potential conflicts of interest between shareholders and nonshareholders. As the potential for conflicts of interest escalates, the likelihood that directors' business judgment will be biased against longterm shareholder interests intensifies. At a minimum, lack of shareholder input amid such conflict of interest adds to the uncertainties that directors face in determining an optimal course for longterm shareholders.[42] Accordingly, as the potential for conflicts of interest increases, the need for shareholder input similarly rises.

Conflicts appear in numerous corporate transactions including executive compensation and the dismissal of shareholder derivative suits. Such conflicts of interest, however,

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tion, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777, 787-88 (1972) (explaining the nature of the control exerted by residual claimants over management).

36. *See* Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1073 (1990).

37. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k) (1991).

38. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 1 (1976).

39. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c) (1991).

40. *See, e.g.*, *id.* § 275.

41. *See, e.g.*, *id.* § 271.

42. > [T]he inevitable uncertainties with respect to application of the business judgment rule in particular situations . . . ha[s] contributed to an atmosphere of uncertainty about the protection afforded directors as they act in good faith to meet their responsibilities. [For example,] [s]uch uncertainty could force directors to act defensively out of concern over costly personal litigation rather than in directing and managing the business of the corporation.

R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 8 (1987).

reach peak proportions in takeover scenarios.[43] Economists addressing takeovers tend to adhere to either the market efficiency position[44] or the auction market position,[45] both of which place shareholders in a preeminent status. A shareholder primacy model envisions that directors adopting antitakeover measures will objectively consider the manifold alternatives to maximizing corporate profits, implementing defensive measures primarily to limit inadequate or coercive bids or develop superior bids or restructuring plans.[46]

Second, shareholders are the optimal source of this guidance. Shareholders alone possess unimpeded incentives to maximize share value.[47] By maximizing longterm economic efficiency, shareholders and nonshareholders benefit simultaneously.[48] Directors, lacking such incentives while saddled with conflicting, economically inefficient prejudices,[49] may fail to search out optimal alternatives unless guided by shareholders.

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43. *See* Matheson & Olson, *supra* note 6, at 1484.

44. Under the market efficiency theory, managers shield themselves behind antitakeover devices without having proper accountability to shareholders, thus usurping market power while stripping themselves of the incentive to run a more efficient corporation. Proponents of this view argue that tender offers help monitor target management performance. Thus, takeovers maximize efficiency either by allowing suboptimal directors and managers to be taken over or by motivating directors to run the corporation more efficiently; essentially, the "market" monitors managerial performance while shareholders hold management accountable for profit performance. Further, this enhanced efficiency generates more wealth for both shareholders and nonshareholder constituencies. Under this theory directors should remain "passive" amid control change transactions. *See* Matheson & Olson, *supra* note 6, at 1493-94.

45. A more moderate approach focuses on the use of defensive antitakeover weaponry, such as poison pills, to facilitate an auction market amid hostile overtures. While the existence of an auction market will generate greater premiums for shareholders, of more significance is the fact that such a market will maximize the likelihood of assuring the most productive match among raider and target. This optimal "match" maximizes longterm economic efficiency. Delaware courts have traditionally embraced the modified "auction model" for corporate control. *See id.* at 1494-95.

46. *See* John H. Matheson & Jon R. Norberg, *Hostile Share Acquisitions and Corporate Governance: A Framework for Evaluating Antitakeover Activities*, 47 U. PITT. L. REV. 407, 409-10 (1986) (explaining development of antitakeover measures); Matheson & Olson, *supra* note 6, at 1437-38 (describing corporate management's response to takeover attempts and the goals of such activity).

47. *See* BERLE & MEANS, *supra* note 34, at 301.

48. *See* Matheson & Olson, *supra* note 6, at 1491.

49. *See id.* at 1483-87 (explaining directors' conflict of interest).

B. MANAGERIAL CAPITALISM AND LONGTERM CORPORATE WELFARE

Whether or not theoretically sound, the reign of the economic-based shareholder primacy concept of corporate governance was short-lived. Stressing separation of ownership from control as the most important factor in modern corporate governance, Adolf Berle and Gardiner Means questioned the reality of "shareholder primacy" in 1932 in their classic work, *The Modern Corporation and Private Property*.[50] They claimed that shareholders were merely passive owners; managers provided the true locus of control amid pervasive shareholder passivity. Berle and Means asserted that, in an increasing number of large companies, management was not chosen by shareholders but rather was a self-perpetuating oligarchy.[51] Management controlled the director nomination process and the proxy machinery.[52]

With this provocative background, debate over the proper corporate objective and the propriety of managers' diverging from the goal of profit maximization has raged without repose. In the early 1930s, Berle and Professor E. Merrick Dodd debated the scope of management's responsibility. Berle asserted that, based on fiduciary duties owed shareholders, "powers granted to a corporation . . . are necessarily and at all times exercisable only for the ratable benefit of all the shareholders."[53] Dodd countered that public policy demands that a corporation be "an economic institution which has a social service as well as

50. BERLE & MEANS, *supra* note 34, at 244.

51. *Id.* at 124; *see* Dent, *supra* note 14, at 907.

52. BERLE & MEANS, *supra* note 34, at 124; *see also* Dent, *supra* note 14, at 882 ("So long as management controls proxies, corporate governance reform efforts are doomed."). Dent also explains:

> [I]f shareholders are supposed to select directors, it is incongruous to vest proxy control in incumbents seeking re-election. This is like letting legislators fund their re-election campaigns from the public treasury while requiring challengers to pay their own way. This system makes the board a self-perpetuating oligarchy and, once management controls the board, the tool for managerial control of the firm. In short, the system generates the separation of ownership and control.

Id. at 906-07; *see also* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 419-20 (1983) (stating that "shareholders' involvement in the voting process has not increased with the adoption of the proxy rules").

53. Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931).

a profit-making function."[54] This debate demarcated the initial boundaries between a fiduciary shareholder primacy norm and a longterm corporate welfare norm.[55]

The potential separation of ownership and control enhances the likelihood that those controlling the corporation will lack an incentive to maximize efficiency and shareholder profitability because of pressures to diverge from the interests of shareholders. With the separation of ownership from control also came the potential for managers to pursue their own self-interested agendas more aggressively within the corporate framework. When directors face claims for consideration from multiple interests or are self-interested,[56] shareholders cannot rely fully upon the directors' business judgment. This leaves the fiduciary duty owed to shareholders in disarray.[57]

Delaware law, for example, provides that either the disinterested board members, the shareholders, or the courts may validate a transaction in which managers' interests clearly diverge from those of shareholders.[58] *Weinberger v. UOP, Inc.*[59]

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54. E. Merrick Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932).

55. *See* Schwartz, *supra* note 14, at 521.

56. This conflict between duty and self interest arises either when directors stand on both sides of a transaction or when they may otherwise reap some personal benefit from their actions.

57. *See* John C. Carter, *To Whom is a Corporate Director a Fiduciary?*, NAT'L L.J., July 6, 1987, at 21, 22; *see also* Dodd, *supra* note 54, at 1149 (arguing that corporate boards should act as trustees for numerous constituencies); Herbert S. Wander & Alain G. LaCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29, 38-44 (1986) (describing current judicial concern with the due care exercised by corporate boards).

For example, courts generally hold that during a takeover attempt a target board breaches its fiduciary duty only when its antitakeover tactics are motivated "solely or primarily" to perpetuate control of the corporation. *E.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir.) (finding that "defensive" acquisitions do not constitute a breach of fiduciary duty unless fending off a merger was the sole reason for the acquisitions), *cert. denied*, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 378 (2d Cir. 1980) (stating that "a director does not necessarily breach any duty owed to the corporation by promoting a change of management"). However, with few exceptions, directors have successfully demonstrated that they were at least partially motivated by legitimate corporate concerns. *See* Gary G. Lynch & Marc I. Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901, 926 (1979) (stating that "management can easily manufacture a 'legitimate' corporate purpose"). *But see, e.g.*, Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 266-67 (2d Cir. 1984) (concluding that an employee stock option plan (ESOP) was created "solely as a tool of management self-perpetration," and therefore was not legitimate).

58. *See* Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987); Merritt v. Colo-

developed the modern formula for judicial review of transactions involving conflicts of interest. *Weinberger* held that "directors . . . [who] are on both sides of a transaction . . . are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."[60]

But the types of conflicts and self-interested actions engendered by managerial capitalism typically do not call into play this strict standard of review. Rather, such conflicts are more subtle. For example, the pursuit of longterm stability, the reinvestment of earnings, and the growth and diversification of the corporate business tends to solidify the corporate enterprise and maintain managers in their positions. From this perspective, current earnings and profits may take on secondary importance.[61]

As the nature of the corporation changed, so did the nature of corporate law. Corporate codes became "enabling," thereby presumptively allowing contracting parties (i.e., managers and investors) much flexibility to determine the terms of the corporate charter and to establish corporate governance regimes free from most legal intervention.[62]

To be effective tools for efficient contracting, these enabling corporate codes presume the ability of contracting parties to make their wishes known. Despite the original conception of the corporation, in which the theoretical (or subsequent) shareholders exercised primary control, modern corporate codes developed their essential character when "[e]ach shareholder owned few shares and lacked the means or inclination to participate actively [in corporate matters]."[63] The separation of ownership from control and the concomitant ability of managers to control the proxy process therefore leaves owners without traditional control or the ability to negotiate effectively

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nial Foods, 505 A.2d 757, 764 (Del. Ch. 1986); *see also* DEL. CODE ANN. tit. 8, § 144(a) (1991) (noting the presumptive validity of transactions approved by disinterested directors or shareholders).

59. 457 A.2d 701 (Del. 1983).

60. *Id.* at 710.

61. As to these actions, strict judicial scrutiny does not come into play. Rather, the courts apply the hands-off business judgment rule to directors' informed decisions, erecting a presumption of good faith, thereby barring legal intervention which might substitute judicial judgment for those actions presumptively best left to managers. *See infra* part I.D.3 (noting the growing judicial deference to board decisions).

62. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1417 (1989).

63. Dent, *supra* note 14, at 883.

with management. The resulting loss in efficiency and the expense in designing alternative means to control management discretion have been aptly described as "agency costs."[64]

Theoretically, then, Berle and Means also foreshadowed the arrival of a competing school of thought, the "longterm corporate welfare" model,[65] which posits that managers should seek to maximize longterm corporate health irrespective of effects on short-term shareholder wealth.[66] Accordingly, under case law and developing modern statutes, directors may consider nonshareholder interests in arriving at longterm business strategies, including the interests of employees, creditors, communities, customers, and suppliers.[67]

C. MONITORING MANAGEMENT

Most current reform proposals proceed from the sometimes unstated premise that governance reforms would be unnecessary but for the separation of ownership and control.[68] That is, while there is dispute over the validity of the Berle and Means thesis, commentators agree that potential conflicts of interest between managers and shareholders are omnipresent.[69] Thus, one great challenge of corporate law is to minimize agency costs by constraining abuse of managerial discretion.

Agency costs stemming from the ownership/control dichotomy may be minimized in a variety of ways. First, corporate law imposes liability for breaches of fiduciary duties. These

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64. *See, e.g.,* Michael C. Jensen & W.H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 293 (1988).

65. *See* BERLE & MEANS, *supra* note 34, at 312; Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365, 1367 (1932). *But see* Dodd, *supra* note 54, at 1149 (stating that "business is permitted and encouraged by the law primarily because it is of service to the community rather than because it is a source of profits to its owners"); E. Merrick Dodd, *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?,* 2 U. CHI. L. REV. 194 (1934).

66. The chief proponent of this model is Martin Lipton. *See, e.g.,* Lipton & Rosenblum, *supra* note 12, at 189 ("[T]he ultimate goal of corporate governance is the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy.").

67. Matheson & Olson, *supra* note 6, at 1469-70.

68. *See* Dallas, *supra* note 14, at 22.

69. Stressing the central importance of conflicting interests for corporate law, Dean Robert Clark has noted that *"[t]he overwhelming majority of particular rules, doctrines and cases in corporate law are simply an explication of [the duty of loyalty] or of the procedural rules and institutional arrangements involved in implementing it."* CLARK, *supra* note 6, § 1.5, at 34.

rules historically have operated on the assumption that the corporation should be managed primarily to maximize shareholder interests.

Fiduciary principles constrain managerial discretion by governing the web of agency relationships constituting the corporate structure.[70] Charged with managing the corporation,[71] a director owes a fiduciary duty to shareholders to act in their best interests.[72] This duty of care is circumscribed by the business judgment rule, the common law "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interests of the company."[73] Consistent with the business judgment rule, liability will not attach for breach of the duty of care unless the director acted with gross negligence.[74] Courts have carved out two limitations to application of the rule: first, there cannot be a breach of the duty of loyalty;[75] second, directors must fulfill their duty to inform themselves of all material information reasonably available before making the decision.[76]

In addition to the fiduciary duties, there has been a push by regulatory authorities and, to some extent, shareholders, to require that corporations have some independent directors on their boards. The purpose for this requirement is the presump-

70. *See* Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 6, at 700 ("The entire corporate structure is a web of agency relationships. Investors delegate authority to directors, who subdelegate to upper managers, and so on.").

71. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business [of a corporation] . . . shall be managed by or under the direction of a board of directors . . . .").

72. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 273 (2d Cir. 1986) (applying a reasonable diligence standard); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders." (citing Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938), *aff'd*, 5 A.2d. 503 (Del. Super. Ct. 1939))).

73. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). The business judgment rule is a creation of common law. "There are no statutory formulations of the business judgment rule." Proposed Final Draft, *supra* note 14, § 4.01(c) cmt., at 227. By invoking the business judgment rule, courts seek to avoid second-guessing the merits of a business decision provided there is no evidence of bad faith or self-dealing. *See Aronson*, 473 A.2d at 812.

74. *Aronson*, 473 A.2d at 812 n.6.

75. *Id.* at 812.

76. *Id.* *Van Gorkom* is the seminal case holding that before directors may garner protection under the business judgment rule, a minimum level of care as evinced by their gathering and reviewing pertinent information is required. 488 A.2d at 458-72.

tion that such directors, independent of management, will monitor management activities for the benefit of shareholders.

Much scholarship[77] and case law[78] adheres to this modified form of the shareholder primacy model, which relies upon monitoring mechanisms to limit managerial discretion in an effort to conform managerial conduct with the interests of shareholders. Thus, according to this model, corporate law provides the mechanisms to minimize agency costs by guaranteeing that management will attempt to maximize shareholder value.

This discretion-constraining model of corporate governance stresses that managers, inclined to pursue their own selfish motives, have intrinsic conflicts of interests with shareholders.[79] Reconciling the shareholder primacy tenet with the Berle and Means thesis, scholars endorsing this model assert that the law must impose controls on management to ensure it is responsible to shareholders and the public.[80]

Managers and directors, however, are not inherently self-interested—after all, most managers and directors diligently attempt to maximize shareholder value.[81] Furthermore, numer-

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77. *See, e.g.*, LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209-18 (1988) (proposing that in order to maximize shareholder participation in corporate governance, institutional shareholders should nominate roughly 25% of the board); Gilson, *A Structural Approach*, *supra* note 6, at 878-79 (proposing a rule that constrains management's ability to interfere with shareholders' tender offer decisions). *Compare* Easterbrook & Fischel, *The Proper Role*, *supra* note 6, at 1191, 1201 (advocating managerial passivity amid takeovers to maximize shareholder value) *with* Bebchuk, *supra* note 6, at 1030 (advocating an auctioneering model in which target managers solicit competing bids).

78. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986) (stating that the primary criterion for judging the legality of poison pills is "the goal of stockholder wealth maximization"), *rev'd on other grounds*, 481 U.S. 69 (1987); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182, 184 n.16 (Del. 1986) (explaining that the interests of shareholders become the directors' sole concern when the corporation is for sale); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

79. *See* Easterbrook & Fischel, *The Proper Role*, *supra* note 6, at 1169-70 (stating that discipline serves to check management's tendency "to shirk responsibilities, consume perquisites, or otherwise take more than the corporation promised to give them"); Gilson, *A Structural Approach*, *supra* note 6, at 836 (unless checked, management will seek "to maximize their own welfare rather than the shareholders' ").

80. *See* Elliott Goldstein, *The Relationship Between the Model Corporation Act and the Principles of Corporate Governance: Analysis and Recommendations*, 52 GEO. WASH. L. REV. 501, 501 (1984).

81. *See* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 30 (1989).

ous corporations provide managers with financial incentives to maximize corporate profitability, thereby tending to align shareholder and nonshareholder interests.[82] The combined effect of these factors, together with the monitoring provided by shareholders, supplies the strongest support for the claim that monitoring mechanisms effectively minimize agency costs.

Market forces, like the market for corporate control, may also constrain managerial abuses. At one extreme, this monitoring model views shareholders as owners of the corporation and posits that ownership of stock is like ownership of any other property.[83] Unhappy shareholders can sell their shares to others. At the least, such conduct should evidence their displeasure with management. If sold to a bidder in a tender offer, such a sale might result in the ouster of management. Throughout the 1970s and much of the 1980s, this market in corporate control acted as an important mechanism monitoring corporate behavior.[84]

Consistent with the market monitoring model, some scholars assert that corporate law should merely seek to facilitate the operation of the market and reduce transaction costs.[85] This market model posits that the corporation merely substitutes for costly multiple contractual arrangements to increase efficiency and maximize profits.[86] Supporters of the market model tend to ally themselves with the efficient capital market hypothesis which decrees that, even when a change of control is not threatened, stock prices accurately reflect all available information about the corporation, including the extent of agency costs because of management-protecting behavior.[87]

The proponents of the market-monitoring model place sub-

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82. Consider, for example, incentive/merit compensation tied to stock value appreciation, earnings, or profit increases. *See* Lipton & Rosenblum, *supra* note 12, at 196-97.

83. *See, e.g.,* Easterbrook & Fischel, *The Proper Role*, *supra* note 6, at 1191, 1201.

84. *See, e.g.,* Matheson & Olson, *supra* note 6, at 1435-38.

85. *See, e.g.,* Fischel, *The Corporate Governance Movement*, *supra* note 14, at 1264-65; Fischel, *The "Race to the Bottom,"* *supra* note 14, at 921; *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 14.3, at 296 (2d ed. 1977) (noting that the primary purpose of corporate law is to provide standard contractual terms that facilitate the bargaining process).

86. *See* Schwartz, *supra* note 14, at 523.

87. For a general overview of materials relevant to the efficient capital market hypothesis, see ROBERT W. HAMILTON, CORPORATION FINANCE 252-95 (2d ed. 1989); Easterbrook & Fischel, *Takeover Bids*, *supra* note 6, at 1734. In Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,264 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d

stantial emphasis on the invisible hand of the marketplace.[88] They stress that the optimal governance structure must derive from experience rather than theory. Corporations persuading shareholders that they offer the highest return will garner the largest investments. Thus, only firms and managers making choices which investors would ordinarily prefer will prosper relative to other companies.[89]

Discretion-constraining rules are thus thought unnecessary to the extent market forces sufficiently curb managerial discretion.[90] Economists claim that capital market discipline caused by managers' incentive to sell stock for maximum value, labor market discipline involving *ex post* evaluation of managers, and product market discipline together adequately limit managerial discretion.

The strength of this combined legal- and economic-based modified shareholder primacy model of corporate governance is uncertain. As discussed next, shareholders' ability to dislodge entrenched management during ongoing control transactions proved intolerable to nonshareholder forces. Nonshareholders responded by devising ways to stultify shareholder input while expanding director discretion. This has resulted in the "insulated managerialism" norm of corporate governance.

D. Insulated Managerialism

While there is debate over the efficacy of internal and market-monitoring mechanisms, including the hostile takeover, there is no doubt that corporate management, the courts, and state legislators responded to the perception, if not the reality, of the concept of monitoring. In the middle to late 1980s, most of the response came in decisions and statutes limiting the ability of potential acquirors to go directly to shareholders to gain control of a target corporation.[91] Statutes limiting or eliminating potential officer and director liability also provided insula-

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1140 (Del. 1989), Chancellor Allen questioned the infallibility of the efficient market hypothesis.

88. *See, e.g.,* Easterbrook & Fischel, *supra* note 62, at 1419 ("Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart. It is almost as if there were an invisible hand.").

89. *See id.* at 1421.

90. *See* Black, *supra* note 13, at 578-79.

91. *See infra* part II.D.1 (describing business combination and control share statutes).

tion.[92] Since management already controlled the proxy machinery, giving management substantially more control over the prospect and process of control transactions brought forth an era of insulated managerialism.

1. Legislation Minimizing Market Monitoring and Shareholder Input

Most public corporations are shielded by now-ubiquitous state-imposed antitakeover legislation,[93] which typically endows management with the power to reject unwelcome takeover overtures.[94] These antitakeover provisions come in all shapes and sizes, including fair price statutes,[95] disclosure statutes,[96]

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92. *See infra* part II.D.2 (discussing legislation immunizing director liability).

93. Johnson, *supra* note 14, at 909; Matheson & Olson, *supra* note 6, at 1439 ("By January 1, 1991, at least 44 states had adopted antitakeover statutes of some kind.").

94. *See, e.g.*, Macey, *supra* note 10, at 468-69 (noting that all state statutes "share the common feature of serving to consolidate the ability to respond to tender offers in the hands of the incumbent managers of [target firms]").

95. Aimed at front-end loaded two-tiered offers, fair price statutes seek to ensure that all target shareholders are offered and receive a "fair price" for all shares—whether tendered during the "first tier" or "second tier"—unless the offer is approved by a super-majority of noninterested shareholders. *See* Matheson & Olson, *supra* note 6, at 1445. Most fair price statutes are based on Maryland's two-tier offer cash-out merger model. This model requires an "interested shareholder" to satisfy the statute's fairness requirement—by offering to the remaining minority the highest price paid any other shareholder before the merger announcement. Failure to satisfy the fairness requirement triggers a prohibitive super-majority statutory requirement: 80% of all the shareholders and two-thirds of all disinterested shareholders (i.e., shareholders other than the bidder) *must vote* to approve a cash-out merger. MD. CORPS. & ASS'NS CODE ANN. §§ 3-602, 3-603 (1985).

96. Paralleling the disclosure requirements of the Williams Act, these statutes typically require disclosure of the suitor's source of funds, the restructuring plans involving the target corporation, and the number of shares the suitor owns directly (or as a beneficiary). As to the overall benefits to shareholders of state-level disclosure statutes, the United States Supreme Court in Edgar v. MITE Corp., 457 U.S. 624 (1982), was

> unconvinced that the Illinois Act substantially enhances the shareholders' position. The Illinois Act seeks to protect shareholders of a company subject to a tender offer by requiring disclosures regarding the offer, assuring that shareholders have adequate time to decide whether to tender their shares, and according shareholders withdrawal, proration, and equal consideration rights. However, the Williams Act provides these same substantive protections . . . . [T]he disclosures required by the Illinois Act which go beyond those mandated by the Williams Act . . . may not substantially enhance the shareholders' ability to make informed decisions . . . . [We] conclude that the protections the Illinois Act affords resident security holders are, for the most part, speculative.

share rights plan endorsement statutes,[97] anti-greenmail statutes,[98] and cashout/redemption rights statutes.[99] Two antitakeover statutes—the business combination statute and the control share acquisition statute—overshadow the others. They demonstrate how far legislatures have gone toward bolstering the pro-management antitakeover landscape.

Legislatures often enact antitakeover statutes hastily, without notice to or input from the public.[100] As suggested by the character and pervasiveness of the recent waves of antitakeover legislation,[101] legislators do not consider shareholders a favored

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Id. at 644-45.

97. These statutes explicitly authorize directors to implement discriminatory poison pills. Most Shareholder Rights Plan Endorsement Statutes (SRPES) allow directors to design poison pills which may include restrictions or conditions that preclude or limit the exercise, transfer, or receipt of such rights by any suitor, or invalidate such rights held by a suitor. *See, e.g.*, IND. CODE ANN. §§ 23-1-35-1(f), 23-1-26-5 (Burns 1989); OHIO REV. CODE. ANN. §§ 1701.16, 1701.13(f)(7) (Baldwin 1989).

98. Anti-greenmail statutes attempt to eliminate abuses associated with a target's payment of "greenmail," i.e., where the target repurchases, at a price above its fair market value, its own stock held by an unwanted suitor. *See, e.g.*, MINN. STAT. § 302A.553 (1990). These statutes generally prohibit a target from purchasing, for more than fair market value, 3% or more of its own stock from any shareholder who has held the shares for less than two years. Most statutes provide that the restrictions do not apply if both the board and a majority of shareholders approve the repurchase. *See id.*

99. Pennsylvania and Maine have enacted statutes which grant "appraisal rights" to nontendering shareholders, entitling them to receive "fair value" when the suitor acquires a threshold percentage of the target's shares. ME. REV. STAT. ANN. tit. 13A, § 910 (Supp. 1990); PA. STAT. ANN. tit. 15, §§ 2546, 2547 (Purdon Supp. 1991). Since the appraisal remedy may require *payment of* a judicially determined "fair" price, it introduces into the bidding process costly risks—the judge's determination of "fair value" will surely generate much litigation; as risks increase, bids will be deterred. Although cashout statutes grant shareholders the same protection as Maryland-type fair price statutes, cashout statutes effectively require the bidder to acquire 100% percent of the firm: their mandatory redemption procedures guarantee all shareholders a fair price. *See* Matheson & Olson, *supra* note 6, at 1451-52.

100. Romano, *supra* note 10, at 138-39; *see* P. John Kozyris, *The Federal Role in Corporate Takeovers: A Framework for a Limited Second Congressional Intervention to Protect the Free Market*, 51 OHIO ST. L.J. 263, 263 (1990) (arguing that despite the "unprecedented" transfer of power from the shareholders to management, antitakeover legislation is "enacted without any substantive debate").

101. We have previously stated:

> [A]ntitakeover statutes have been enacted in three waves. First-generation statutes were enacted in response to the spell of takeover activity in the late 1960s, and often paralleled the requirements of the Williams Act. Second-generation statutes were passed in response to the Supreme Court's rejection of first-generation statutes announced in *Edgar v. MITE Corp.* Third-generation statutes are those that have

constituency. Since shareholders are rarely concentrated locally, their interests are systematically under-represented.[102] Further, since the expected gains of local nonshareholder antitakeover forces generally exceed those of resident shareholders, nonshareholders have far more incentive to direct resources toward supporting antitakeover legislation.[103]

What motivates states to enact antitakeover legislation? Wary of raiders' tendencies to liquidate companies, close plants and lay off workers, state legislators seek to protect home-based businesses.[104] More specifically, the impetus likely derives from two sources: the enacting state's desire to protect nonshareholder constituencies,[105] including managers who are unable or unwilling to persuade shareholders of the value of internal defensive measures,[106] and financial protectionism, where states desire to retain and maximize tax-generating

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> been passed since *CTS Corp. v. Dynamics Corp. of America*, where the Supreme Court upheld Indiana's second-generation statute.

Matheson & Olson, *supra* note 6, at 1438-49 (footnotes omitted).

102. *See* Macey, *supra* note 10, at 488-89.

103. *See* Kenneth B. Davis, Jr., *Epilogue: The Role of the Hostile Takeover and the Role of the States*, 1988 WIS. L. REV. 491, 501. Professor Davis notes that "because the activities of the antitakeover interests tend to be more local, these interests are more likely to be well-organized at the state level. Labor unions and municipalities typically have statewide associations; institutional investors do not." *Id.*

104. *See* Alan E. Garfield, *Evaluating State Anti-takeover Legislation: A Broadminded New Approach to Corporation Law or "A Race to the Bottom"?*, 1990 COLUM. BUS. L. REV. 119, 126; Johnson & Millon, *Williams Act*, *supra* note 10, at 1864 (noting that deterrence of takeovers, not "investor protection," is the state's primary motivation); *cf.* Macey, *supra* note 10, at 476 ("Managerial self-interest remains the sole explanation for state anti-takeover legislation."). Garfield explains:

> [A] study of takeover statutes suggests that these statutes are not employee protective but management protective. By attempting to stop takeovers, the statutes serve only one purpose: to entrench current management in power. Nothing in the legislation ties the hands of current managers from engaging in the same dislocative conduct attributed to acquirors. The legislators are simply hoping that by protecting current managers, they will perpetuate current management policies, including the current deployment of corporate assets and jobs.

Garfield, *supra*, at 126.

105. More than half the states have adopted provisions which expressly allow directors to consider nonshareholder interests in responding to takeover bids. *See* Matheson & Olson, *supra* note 6, at 1500-01, 1538 (identifying 29 states that have enacted some form of these statutes).

106. State antitakeover legislation is often adopted at the request of potential target corporations reluctant to propose the defenses embodied in the statutes. *Id.* at 1501.

resources.[107]

a. *Bypassing Shareholder Input Regarding "Business Combinations"*

At least twenty-eight states have enacted business combination statutes that prohibit most business combinations[108] between a target corporation and an "interested" shareholder absent prior board approval.[109] Allowing a board to decide unilaterally whether business combination legislation is applicable grants the board ultimate power to determine whether to accept a tender offer. Most of these statutes render shareholders wholly powerless to accept tender offers by guaranteeing that no such offer will be brought to fruition without target board approval.

For example, New York's law prohibits business combinations between resident domestic corporations and a twenty percent shareholder for five years absent prior board approval.[110] Delaware modified New York's statute[111] by establishing a three-year prohibition on any business combination between a

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107. Justice Powell has stated:

> The corporate headquarters of the great national and multinational corporations tend to be located in the large cities of a few States. When corporate headquarters are transferred out of a city and State into one of these metropolitan centers, the State and locality from which the transfer is made inevitably suffer significantly. Management personnel—many of whom have provided community leadership—may move to the new corporate headquarters. Contributions to cultural, charitable, and educational life—both in terms of leadership and financial support—also tend to diminish when there is a move of corporate headquarters.

Edgar v. MITE Corp., 457 U.S. 624, 646 & n.* (1982) (Powell, J., concurring in part).

108. "Business combination" is a comprehensive term including virtually every conceivable type of fundamental change. *See, e.g.*, DEL. CODE ANN. tit. 8, § 203(c)(3) (1991); N.Y. BUS. CORP. LAW § 912(a)(5) (McKinney 1986).

109. *See* Matheson & Olson, *supra* note 6, at 1521-29 (identifying 28 states).

110. N.Y. BUS. CORP. LAW § 912 (McKinney 1986). The New York statute prohibits both two-step bids and coercive two-tier bids. *See* Booth, *supra* note 10, at 1676. With two-tier bids, the bidder announces in advance that, once control passes, the remaining shareholders will be cashed out at a lower price than those who initially tendered in the first tier, coercing some shareholders to tender for less than they otherwise would. *Id.* The New York statute essentially prohibits hostile takeovers if the suitor plans to change the target's business significantly. *Id.*

111. Delaware's statute is manifestly less restrictive than New York's—indeed, the Delaware statute is one of the mildest in the nation: it applies only to suitors who acquire between 15% and 85% of a target's shares. *See* DEL. CODE ANN. tit. 8, § 203(a)(2), (c)(5) (1991); Booth, *supra* note 10, at 1675 n.148.

Delaware corporation and an "interested" stockholder[112] acquiring fifteen percent or more of the company unless the board of directors gives prior approval.[113] Since the Delaware law covers more corporations than any other,[114] the business combination statute is currently the most pervasive form of antitakeover legislation.

b. *Minimizing Shareholder Input Regarding Voting Rights for "Control Shares"*

No less than twenty-seven states have enacted control share statutes[115] which, following Indiana's lead, afford shareholders the right to determine collectively whether bidders' "control shares" accrue voting rights.[116] Despite this pro-share-

112. "Interested Stockholders" are shareholders that possess 15% or more of a corporation's voting stock. DEL. CODE ANN. tit. 8, § 203(c)(5) (1991).

113. *See id.* § 203(a)(1). In addition to this prior board approval, the Delaware statute provides two additional pathways for a suitor to circumvent the three-year freeze. First, the suitor may override the freeze if the qualifying transaction results in a suitor's owning at least 85% of the target stock. *Id.* § 203(a)(2). Second, the suitor may override the freeze if the business combination is approved by both the board and by two-thirds of the outstanding disinterested shares. *Id.* § 203(a)(3). The Delaware statute has withstood constitutional challenges. *See, e.g.*, BNS, Inc. v. Koppers, 683 F. Supp. 458 (D. Del. 1988).

114. Fifty-six percent of the Fortune 500 firms are incorporated in Delaware. Forty-five percent of the firms listed with the New York Stock Exchange have Delaware as their corporate home. Dale A. Oesterle, *Delaware's Takeovers Statute: Of Chills, Pills, Standstills, and Who Gets Iced*, 13 DEL. J. CORP. L. 879, 883-84 (1988).

115. *See* Matheson & Olson, *supra* note 6, at 1533-37 (table identifying and discussing statutes in 27 states).

116. *See* IND. CODE ANN. § 23-1-42 (Burns 1989). Indiana based its passive law on the more restrictive Ohio Control Share Acquisition Statute. *See* OHIO REV. CODE ANN. § 1701.831 (Baldwin 1989). Ohio's control share law differs from Indiana's law in one important way: the Ohio Act requires advance shareholder approval for the bidder to purchase shares which lift its ownership over the relevant thresholds (20%, 33%, and 50%). *See* Booth, *supra* note 10, at 1678 n.157. Also, the Ohio statute focuses on the stock itself (rather than the voting rights of the stock) in requiring the approval of disinterested shareholders. *See* OHIO REV. CODE ANN. § 1701.831(A), (E) (Baldwin 1989).

Indiana's law prohibits the acquiror of 20% or more of the target's shares from voting those shares unless a majority of noninterested shareholders grant the acquiror voting rights. IND. CODE ANN. § 23-1-42-9 (Burns 1989). Indiana's law requires additional noninterested shareholder votes when the acquiror attains over one-third and one-half, respectively, of the total target's voting power. Upon filing an "acquiring person statement" with the target, the acquiror may request that a vote be held within 50 days. Upon failing to garner adequate shareholder votes, the target may redeem the acquiror's shares at fair market value; if acquirors prevail in the vote and subsequently acquire a majority of the shares, dissenting shareholders may elect to be cashed out at holder appearance, the essential purpose of control share acquisition statutes may be to endow the target board with the power to dispose of tender offers. The powers granted directors under these statutes are vast. They include the power to opt into or out of statutory protection;[117] the power to control the timing of the shareholder meeting;[118] the power to approve a merger unilaterally, thereby bypassing the statute;[119] the power to issue stock to a "white knight" without triggering the statute's provisions;[120] and the power to engage in friendly control transactions.[121] In addition, the requirement that a meeting and vote be held causes significant delay and attendant costs for the potential acquiror. More fundamentally, however, control share statutes dramatically alter the corporate control terrain. Instead of making an investment decision, that is, whether to sell their shares, shareholders are asked to vote on the acquiror's voting rights. Once again, this creates a proxy contest in which management can influence shareholders or rely on presumed passivity. Thus, although control share statutes in theory grant shareholders a much needed voice in control transactions,[122] their ultimate effect is to grant directors one more means of minimizing shareholder input.

The popularity of these statutes likely stems from the fact that they are the only variety of protectionist legislation upheld by the Supreme Court.[123] As an antitakeover weapon, armed

the highest price per share paid by the acquiror in her control share acquisition. *See id.*

117. *See, e.g.*, IND. CODE ANN. § 23-1-42-5 (directors may unilaterally amend bylaws, thereupon controlling election to opt in/out).

118. *See, e.g., id.* § 23-1-42-7(b).

119. *Id.* § 23-1-42-2(d)(5) (acquisition of shares not deemed a control share acquisition if pursuant to a plan of merger or plan share exchange).

120. *See, e.g.*, MINN. STAT. § 302A.011 subd. 38(e) (1990) (exempting shares issued directly by the target corporation from the statute's coverage); MINN. STAT. ANN. § 302A.671 reporter's notes.

121. MASS. GEN. L. ch. 110 D, § 1(c)(2)(vi) (1990); VA. CODE ANN. § 13.1-728.1(6) (Michie 1988).

122. *Cf.* Allen Boyer, *When it Comes to Hostile Tender Offers, Just Say No: Commerce Clause and Corporation Law in* CTS Corp. v. Dynamics Corp. of America, 57 U. CIN. L. REV. 539 (1988). Boyer hails control share statutes as empowering shareholders to defeat or accept hostile offers, arguing that the ultimate effect of control share statutes is to give shareholders a voice, provide a mechanism for making this voice heard, and expand shareholders' role in corporate governance. *Id.* at 539.

123. These statutes were believed to be pro-shareholder to the extent that they allow shareholders to vote collectively, thereby mitigating coercion:

> If, for example, shareholders believe that a successful tender offer will be followed by a purchase of non-tendering shares at a depressed price, individual shareholders may tender their shares — even if they

with disinterested shareholder approval requirements and redemption and dissenters' rights, control share acquisition statutes impose significant delays which may prove lethal to would be suitors by increasing risks.[124] As a result, potential acquirors will be "extremely reluctant to acquire stock above any of the [statutory] thresholds" lest they become permanently disenfranchised.[125]

c. *Bypassing Shareholder Input by Empowering Directors to Consider Nonshareholder Interests*

Many states have recently enacted legislation directly expanding board discretion by mandating or allowing the boards to consider constituencies other than shareholders. These statutes potentially provide directors with much greater leeway in rejecting tender offers than does current case law.[126] Typically, these multiconstituency statutes explicitly allow individual directors to consider nonshareholder interests. One such statute, recently passed in Minnesota, provides in pertinent part:

> a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community

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> doubt the tender offer is in the corporation's best interest — to protect themselves from being forced to sell their shares at a depressed price . . . . [Thus], the shareholders as a group, acting in the corporation's best interest, could reject the offer, although individual shareholders might be inclined to accept it.

CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 83 (1987) (citing Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs, SEC Exchange Act Release No. 21,079 [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,637 (June 21, 1984)).

124. "Delay has been characterized as 'the most potent weapon in a tender-offer fight.'" Edgar v. MITE Corp., 457 U.S. 624, 637 n.12 (1982) (quoting Langevoort, *supra* note 10, at 238 and citing Herbert M. Wachtell, *Special Tender Offer Litigation Tactics*, 32 BUS. LAW. 1433, 1437-42 (1977) and Diane Wilner & Craig A. Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1, 9-10 (1976)).

125. Thomas J. Andre, *A Preliminary Inquiry Into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533, 554 (1990); *cf. CTS Corp.*, 481 U.S. at 95, 97 (Scalia, J., concurring) ("Whether the control shares statute 'protects shareholders of Indiana corporations' or protects incumbent management seems to me a highly debatable question . . . . But a law can be both economic folly and constitutional."). Indeed, Judge Posner considered these *ex ante* deterrences so powerful as to decry Indiana's statute as a "lethal dose" for hostile takeovers. *See* Dynamics Corp. v. CTS Corp., 794 F.2d 250, 262-63 (7th Cir. 1986), *rev'd. in part*, 481 U.S. 69 (1987).

126. Commentators have asserted that these statutes "vest . . . such extraordinary broad discretion in a board" they probably affirm the "just say no" defense. *See* MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS § 5.03[1], at 5-34 (1991).

> and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation.[127]

The constituency statutes are consistent with a theory of corporate law which posits that a corporation is essentially a "nexus of contracts" in which numerous constituencies contract with the corporation for protection and gain. Corporate control is shared among numerous corporate constituencies; shareholders thus comprise only one component of this nexus.[128] This theory is based on the assumption that the firm is but a legal fiction in which parties freely consummate contracts articulating the nature of their relationships[129] and management takes on the character of a central contracting agent.[130]

This shareholder contract derives from three sources: legislation as interpreted by the courts,[131] articles of incorporation, and fiduciary duties.[132] Unlike statutory standard terms, fiduciary duties embody *ex post* evaluation of decisions rather than defining the scope of directors' powers beforehand.[133] As such, fiduciary duties fill gaps left by standard contract terms.[134] State statutes provide that most contractual terms may be amended—typically by majority shareholder vote.[135] Shareholders initially investing in a corporation implicitly agree to abide by majority-approved provisions. A threshold inquiry into the province of corporate law thus involves examining the extent to which governance terms should be determined contractually.[136]

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127. MINN. STAT. § 302A.251, subd. 5 (1990). The effect of such legislation is to "help shield directors from liability by expanding the criteria that directors may consider in reaching decisions on behalf of the corporation." LIPTON & STEINBERGER, *supra* note 126, § 6.02[5], at 6-121.

128. *See* Dallas, *supra* note 14, at 23.

129. *See* Jensen & Meckling, *supra* note 64, at 305.

130. Alchian & Demsetz, *supra* note 35, at 777; Jensen & Meckling, *supra* note 64, at 310.

131. In this sense, corporate statutes provide standard form contractual terms. *E.g.*, DEL. CODE ANN. tit. 8, § 394 (1991) ("This chapter and all amendments thereof shall be part of the charter or certificate of incorporation of every corporation.").

132. These duties may derive from either statute or case law. *See, e.g.*, *id.* § 144 (1991) (implied presumption that a transaction is voidable where director is financially interested).

133. *See* Ribstein, *supra* note 6, at 77.

134. *See id.*

135. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(b)(1) (1991).

136. At one extreme, "[t]he law's role should be to interpret and enforce [shareholders'] contracts." Ribstein, *supra* note 6, at 78.

Shareholder primacy advocates argue that board consideration of nonshareholder interests breeds inefficiency by distorting the free flowing market allocation of resources and by promoting arbitrary management decision making.[137] However, the shareholder primacy model is not unassailable. Shareholders' ownership of stock may not be the equivalent of ownership of private property: unlike typical private property,[138] the corporation is a central productive element of our economy upon which our nation depends for its vitality.[139] Further, shareholder stock ownership frequently appears to be merely a residual financial investment—quite unlike the "use and enjoyment" interest of the owner of personal property.[140]

2. Legislation Limiting Director Accountability

In direct response to *Smith v. Van Gorkom*,[141] the Delaware Legislature enacted Section 102(b)(7) of the Delaware Corporate Code which allows firms to opt out of *Van Gorkom*'s strengthened duty of care standard.[142] It permits companies to amend their articles of incorporation to eliminate monetary liability of directors to the corporation and its shareholders,[143] essentially allowing each firm to adopt its own business judgment rule.[144]

All jurisdictions recognize the power of a corporation, within specified limits, to indemnify its directors and officers against expenses and liabilities incurred while carrying out their duties.[145] These expenses include litigation costs directly

137. *See* Matheson & Olson, *supra* note 6, at 1482-91 (noting that consideration of nonshareholder interests aggravates conflicts of interest which inhere in control change contexts).

138. Lipton and Rosenblum have explained: "To the extent there is an intrinsic nature to the corporation, it is more akin to that of a citizen, with responsibilities as well as rights, than to that of a piece of private property." Lipton & Rosenblum, *supra* note 12, at 193.

139. *Id.* at 192.

140. *See id.* at 193-94 ("Stockholder's intrinsic ownership interest is a financial interest . . . .").

141. 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the Delaware Supreme Court held that the business judgment rule did not protect the directors of a company who breached their duty of care in approving a proposed cash merger. *Id.* at 893.

142. DEL. CODE ANN. tit. 8, § 102(b)(7) (1991); *see* Note, *Limiting Directors' Duty of Care Liability: An Analysis of Delaware's Charter Amendment Approach*, 20 U. MICH. J.L. REF. 543, 548 (1987).

143. *See* DEL. CODE ANN. tit. 8, § 102 (b)(7) (1991).

144. *See* Bradley & Schipani, *supra* note 14, at 7.

145. *See* Proposed Final Draft, *supra* note 14, at part VII, § 7.20 cmt. a, at 905.

resulting from service to the corporation.[146] Most of these statutes provide for mandatory and permissive indemnification. Most jurisdictions follow either the Delaware pattern or the Revised Model Business Corporations Act (RMBCA) pattern.[147]

Delaware law mandates corporate indemnification for expenses incurred in any proceeding to the extent the director has been successful.[148] If the director loses, Delaware law permits indemnification.[149] Corporations may provide for broader indemnification in their bylaws or articles.[150] Section 8.50 of the RMBCA limits indemnity to expenses incurred.[151] The statutes in twenty-eight states, following both the Delaware and RMBCA patterns, expressly limit indemnification in derivative actions to expenses incurred, and preclude indemnification of judgments paid in settlement.[152]

The statutes in every state except Vermont expressly permit corporations to purchase insurance protecting officers and directors against liability.[153] For example, the Delaware statute grants corporations the right to purchase insurance on behalf of any director, officer, employee, or agent of the corporation for liability arising out of such capacity.[154] Thus, the insurance coverage may be broader than indemnity coverage.[155]

3. Judicial Decisions Insulating Management

a. *Employment of Defensive Measures*

Since *Moran v. Household International, Inc.*,[156] corporate

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146. *See, e.g.,* ALA. CODE § 10-2A-21 (1987 & Supp. 1989).

147. *See* REVISED MODEL BUSINESS CORPORATION ACT § 8.50 (1984).

148. DEL. CODE ANN. tit. 8, § 145(c) (1991); *see* Merrett-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 141 (Del. Super. Ct. 1974).

149. *See* DEL. CODE ANN. tit. 8, § 145 (a) (1991).

150. *See* Bradley & Schipani, *supra* note 14, at 32.

151. REVISED MODEL BUSINESS CORPORATION ACT § 8.50 (1984).

152. *See* Proposed Final Draft, *supra* note 14, § 7.20 reporter's note 2.

153. *See id.* § 7.20 reporter's note 4.

154. *See* DEL. CODE ANN. tit. 8, § 145(g) (1991).

155. *See id.* § 145(b) (insurance could encompass liability associated with shareholder derivative action even though otherwise limited under Delaware law).

156. 500 A.2d 1346 (Del. 1985). In *Moran* the Delaware Supreme Court upheld a board's adoption of a shareholder rights plan. The court stated: "[P]re-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment. Therefore, in reviewing pre-planned defense mechanisms, it seems even more appropriate to apply the business judgment rule." *Id.* at 1350. The *Moran* Chancery Court allowed directors to justify their actions

adoption of shareholder rights plans, or poison pills, have become routine matters which easily survive judicial scrutiny.[157] *Moran* opened the door for corporate boards to inject themselves unilaterally into the tender offer or control transaction process, thereby presumptively requiring director approval as a necessary step in the change of corporate control.

Shielded by the business judgment rule, either in its pure or Delaware-modified form, directors have implemented numerous defensive measures to resist hostile takeover bids,[158] including poison pills,[159] stock repurchases, golden parachutes,[160] lock-up agreements,[161] and no-shop provisions.[162]

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based on the interests of one or more corporate constituencies. Moran v. Household Int'l, Inc., 490 A.2d 1059, 1079 (Del. Ch. 1985). The Chancery Court stated that poison pills, if implemented "to protect all corporate constituencies and not simply to retain control, have been consistently approved under the business judgment rule." *Id.*

157. One Pennsylvania trial court held that "adoption of a rights plan *per se*, passed at a time when the company is not a target of a hostile takeover, clearly is valid and no cause of action [by a shareholder] exists." Steiner v. Milton Roy Co., No. 6832, 1989 Phila. Cty. Rptr. LEXIS 58 (Phil. Ct. Comm. Pl. Nov. 9, 1989). For a more detailed survey of relevant case law, see Victor I. Lewkow & William A. Groll, *Selected Issues in Acquisition Defense* (Apr. 11, 1988) *in* KENNETH J. BIALKIN & ARTHUR FLEISCHER, JR., TENTH ANNUAL INSTITUTE ON ACQUISITIONS AND TAKEOVERS (1988).

158. Consistent with the wide latitude the business judgment rule grants directors, courts have upheld a variety of defensive measures. *See, e.g.*, Gearhart Indus. v. Smith Int'l, Inc., 741 F.2d 707, 724 (5th Cir. 1984) (deploying "springing warrants"); Enterra Corp v. SGS Assocs., 600 F. Supp. 678, 688 (E.D. Pa. 1985) (entering into "standstill agreements" whereupon potential offerors agree not to proceed with offer).

159. *See* Ronald A. Brown, Jr., Note, *An Examination of a Board of Directors' Duty to Redeem the Rights Issued Pursuant to a Stockholder Rights Plan*, 14 DEL. J. CORP. L. 537 (1989); Patrick J. Thompson, Note, *Shareholder Rights Plans: Shields or Gavels?*, 42 VAND. L. REV. 173 (1989).

160. These executive termination agreements are "contracts between corporations and their executive personnel guaranteeing generous severance benefits in the event of a corporate takeover." Drew H. Campbell, Note, *Golden Parachutes: Common Sense from the Common Law*, 51 OHIO ST. L.J. 279, 280 (1990).

161. Lock-up options and bust-up fees involve the right to purchase target stock or assets on favorable terms. Without these favorable terms, white knights would not likely assist a target. A target corporation board may grant a white knight the option to purchase key corporate assets, a strategy known as the "crown jewel" defense. *See* Matheson & Olson, *supra* note 6, at 1457-58 n.221.

162. White knights often require no-shop covenants by the target preventing the target from soliciting or encouraging anyone to make a competing bid or otherwise assist would-be acquirors. In Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989), the Delaware Supreme Court invalidated a no-shop provision, asserting that "[a]bsent a material advantage to the stockholders from the terms or structure of a bid that is contingent on a no-shop clause,

The "just say no" defense decrees that a board need not abandon its antitakeover weaponry when surrender defeats the corporation's longterm interests.[163] In *Paramount Communications v. Time, Inc.*,[164] the Delaware Supreme Court held that a board is not under any duty to maximize shareholder value in the short term.[165] Although *Paramount*'s fact-specific holding arguably reaches only those unusual takeover contexts where the target corporation has reached a definitive restructuring plan and has taken all steps necessary to consummate its plan, the court's expansive approach has added much weight to the "just say no" position.[166]

Paramount also illustrates that business planning not primarily designed as an antitakeover scheme[167] may serve as a preplanning defensive strategy.[168] Beyond the use of the "just

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a successful bidder imposing such a condition must be prepared to survive the scrutiny which that concession demands." *Id.* at 1286; *see also* Barkan v. Armstad Indus., 567 A.2d 1279, 1288 (Del. 1989) ("Where a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference the board seeks to forestall competing bids.").

163. For one analysis of the "just say no" defense, see Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377 (1990). Prentice and Langmore define the just say no defense in terms of the nagging question: "Is it ever permissible for target management to refuse to provide an alternative, yet still oppose the hostile tender offer?" *Id.* at 382.

164. 571 A.2d 1140 (Del. 1989).

165. *Id.* at 1150.

166. *See* Kozyris, *supra* note 100, at 263 n.3. (stating that *Paramount* dealt "the ultimate blow against any serious judicial control over management oppositionism").

167. Chancellor Allen held that Time's legitimate "interest" in combining with Warner Communications may be protected by defensive action.

> In my opinion, where the board has not elected explicitly or implicitly to assume the special burdens recognized by *Revlon*, but continues to manage the corporation for longterm profit pursuant to a preexisting business plan that is not primarily a control device or scheme, the corporation has a legally cognizable interest in achieving that plan.

Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,264 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

168. The Delaware court in TW Servs., Inc. v. SWT Acquisition, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,147 (Del. Ch. Mar. 2, 1989), stated that it is "non-controversial" that

> directors, in managing the business and affairs of the corporation may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected, and thus directors in pursuit of long run corporate (and share-

say no" defense to consummate carefully negotiated plans like that found in *Paramount*, the defense may apply if the offer[169] is coercive,[170] or inadequate,[171] and if resisting the offer continues to serve a valid purpose, such as promoting shareholder value.[172]

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holder) value may be sensitive to the claims of other "corporate constituencies."

Id. The recent decision in Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989), buttresses the use of longterm planning as a defensive preplanning strategy. Focussing on longterm corporate goals, the court found Polaroid's pre-planned employee stock option plan "fundamentally fair" despite its highly antitakeover timing and effect. *Id.* at 291.

169. If a suitor insists the target take decisive action (e.g., auction the company) upon the target receiving a bare offer, courts will not force redemption of the company's poison pill. *See, e.g.*, Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis.), *aff'd on other grounds*, 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989). Applying Delaware law, the *Amanda* court stated that Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), and its progeny do not require a target to place itself on the auction block. *Id.* at 1013. In distinguishing Grand Metropolitan PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988), the *Amanda* court stressed that only 27% of Universal's shareholders had tendered as against Pillsbury's 87% tender; Universal was on an upswing, but Pillsbury was on a downswing; and Universal's board had made an informed decision about the adequacy of Amanda's offer, considering 12 alternative responses to the offers. *Id.* at 1013-14. The court also considered that the bid posed a threat to the shareholders who did not tender if Amanda failed to obtain financing; in addition, there was a threat that the offer contained false or misleading information given Amanda's complex financing. *Id.* Apparently, *Amanda* requires that the offer pose a real threat to shareholders. *See* Buckhorn, Inc., v. Ropak Corp., 656 F. Supp. 209, 228 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987). Applying Delaware law, the *Buckhorn* court held that Buckhorn's board had no duty to sell merely because of preliminary negotiations with one potential bidder. *Id.*; *see also* Ivanhoe Partners, Ltd. v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) (shareholder's entering into a 10-year standstill agreement after raising its stake in Newmont to 49.7% from 26% did not amount to a sale of the company requiring Newmont to negotiate with a possible bidder when a bidding contest was not yet underway).

170. Whenever a suitor's coercive or inadequate offer poses a threat to a corporation, courts uphold the defensive measures as "reasonable in relation to the threat posed." *Shamrock Holdings*, 559 A.2d at 286-87 (finding an all-cash, all-shares offer coercive). Other cases have upheld directors' decisions not to sell a corporation because of the coerciveness of an offer. *See* Desert Partners, L.P. v. USG Corp., 686 F. Supp. 1289 (N.D. Ill. 1988). Applying Delaware law, the *Desert Partners* court approved USG's decision neither to negotiate nor to redeem its rights plan amid a hostile, two-tiered offer by Desert Partners. *Id.* at 1300; *see also Unocal*, 493 A.2d at 950 (partial tender offer); *Ivanhoe Partners*, 535 A.2d at 1345 (two-tiered offer).

171. If a board in good faith determines that a bid is inadequate, that alone justifies leaving a pill in place. *See* City Capital Assocs., Ltd. v. Interco, Inc., 551 A.2d 787, 797 (Del. Ch. 1988). *But see Amanda*, 708 F. Supp. at 1014-15.

172. *See, e.g.*, *In re* Holly Farms Corp. Shareholders Litig., 564 A.2d 342 (Del. Ch. 1989). In *Holly Farms*, plaintiff Tyson and its competitor, ConAgra,

b. *Consideration of "Corporate Welfare"*

Although the drive toward the "longterm corporate welfare" norm derives from many sources, the seeds of this proposition originate from judicial enhancement of the concept of "the best interests of the corporation,"[173] a phrase common to corporate statutes and decisions defining a director's duty of care. Some commentators also argue that a corporation has an "independent interest in its own longterm business success."[174] Not until *Unocal Corp. v. Mesa Petroleum Co.*,[175] however, had the Delaware judiciary directly endorsed directors' consideration of nonshareholder constituencies.[176] Since the 1985 decision, twenty-nine states have enacted legislation allowing

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bid for Holly Farms. The court refused to grant a preliminary injunction requiring Holly Farms to redeem its rights plan since the pill served the valid purpose of preventing Tyson from blocking ConAgra's economically superior offer. Since there were no other bidders, the shareholders would be harmed if ConAgra withdrew its offer, rendering legitimate the unredeemed pill. *Id.*

Shareholder interests may also be advanced when the board is granted sufficient time to consider other alternatives. *See Shamrock Holdings*, 559 A.2d at 285-86.

173. For example, the Delaware Chancery court in TW Services, Inc. v. SWT Acquisition, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,147 (Del. Ch. Mar. 2, 1989), equated "shareholder longterm interests" with "multi-constituency interests":

> The knowledgeable reader will recognize that this particular phrase masks the most fundamental issue: to what interest does the board look in resolving conflicts between interests in the corporation that may be characterized as "shareholder longterm interests" or "corporate entity interests" or "multi-constituency interests" on the one hand, and interests that may be characterized as "shareholder short term interests" or "current share value interests" on the other?

Id.

174. *See* Lipton & Rosenblum, *supra* note 12, at 202. Lipton and Rosenblum explain:

> The greater the amount of goods or services the enterprise can sell, and the greater the difference between what the consumer is willing to pay and what the goods or services cost to produce, the greater the profit that inures to the enterprise. Viewed in this light, the corporate enterprise has an independent interest of its own in the successful operation of its business, with success measured in terms of present and expected profit.

Id. at 203.

175. 493 A.2d 946 (Del. 1985)

176. *Id.* at 955 (stating that a director may consider "the impact [of a takeover] on 'constituencies' other than shareholders"). *Unocal* illustrates the degree to which the business judgment rule may be wielded to expand the already broad scope of a director's discretion to bypass shareholder input. Thus, the business judgment rule in the takeover context may allow stakeholder interests to be furthered at the expense of shareholders. *See* Matheson & Olson, *supra* note 6, at 1455-66 (analyzing protectionist case law).

directors to consider nonshareholder constituencies.[177]

How are directors to consider these constituencies in conjunction with the fiduciary duty they owe shareholders?[178] Even during a takeover, if directors focus primarily on shareholders' best interests, both shareholders and stakeholders simultaneously benefit,[179] but numerous problems emerge from a stakeholder model in which directors are allowed to consider stakeholder interests.[180]

First, since a corporation would harm itself by discarding valuable employees or suppliers,[181] the extra protection assists primarily suboptimal employees, suppliers, or creditors who would be affected by a "shareholder primacy" approach.[182] Since most nonshareholders are already protected by other laws,[183] stakeholder problems resulting from board action

177. *See* Matheson & Olson, *supra* note 6, at 1540-45.

178. Until a takeover becomes imminent, directors may consider nonshareholder constituencies in deploying takeover defenses as long as they also benefit the shareholders. *See* Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (stating that a board may consider nonshareholder constituencies "provided there are rationally related benefits accruing to stockholders. . . . However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress [such that the sole duty is] to sell it to the highest bidder."); *see also* TW Servs., Inc. v. SWT Acquisition [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,147 (Del. Ch. Mar. 2, 1989) (noting that "[w]hen a corporation is in a '*Revlon* mode,' legitimate concerns relating to the claims of other constituencies are absent and, indeed, concerns about the corporation as a distinct entity become attenuated."); Mills Acquisition Co. v. MacMillan, Inc. 559 A.2d 1261, 1282 n.29 (Del. 1989) (holding that a board may consider "the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests"); ABA Comm. on Corporate Laws, *Other Constituencies Statutes: Potential For Confusion*, 45 BUS. LAW. 2253 (1990) [hereinafter *Other Constituencies*].

179. *See* Easterbrook & Fischel, *The Proper Role*, *supra* note 6, at 1190-92; *cf. Other Constituencies*, *supra* note 178, at 2269 (suggesting that a better interpretation of directors' duties statutes and related case law allows directors to take into account nonshareholder constituencies, but only "to the extent that the directors are acting in the best interests, long as well as short term, of the shareholders and the corporation").

180. For a recent analysis of directors' duty legislation, see *Other Constituencies*, *supra* note 178, at 2263-70.

181. *See* Easterbrook & Fischel, *The Proper Role*, *supra* note 6, at 1170-71.

182. *See id.*

183. *See Other Constituencies*, *supra* note 178, at 2268 (discussing how creditors, management, employees, and unions have other means of protection); *see also* Gregory R. Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865, 884 (1987) (noting that employees are protected by labor laws and stating that legislation "governing hostile takeovers should not attempt to minimize noninvestors' risks at the expense of our free market system").

under a shareholder primacy perspective would be short term.[184]

Second, requiring accountability to holders of conflicting interests may ultimately harm both groups.[185] Directors who are free to consider nonshareholder interests would be less accountable to shareholders.[186] In addition, the "standard" by which courts articulate a director's duty to stakeholders defies precise definition.[187] The undefined parameters of this "standard" fuels directors' uncertainty regarding their allegiance to shareholders.[188]

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184. In addition, employees or suppliers are usually only temporarily displaced—that is, many constituencies have the capacity to find a replacement for their reliance on the target.

185. *See* Easterbrook & Fischel, *The Proper Role*, *supra* note 6, at 1192; *see also* Andre, *supra* note 183, at 884-85 ("[M]anagement should not be asked or allowed to attempt to carry out the impossible task of acting as fiduciaries for groups with competing interests."); Ronald J. Gilson, *Just Say No to Whom?*, 25 WAKE FOREST L. REV. 121, 126 (1990).

186. In the narrowest sense, when directors are free to consider nonshareholder interests in takeover scenarios rather than focus on the sole objective of maximizing shareholder wealth, their "accountability" is diminished inasmuch as shareholders can less easily monitor a manager's performance. *See* Johnson, *supra* note 14, at 881-84.

Former SEC chairman Davis S. Ruder has explained that director accountability to a clearly defined group (i.e., shareholders) is a cornerstone of the corporate system: "If management duties to others are declared, the process of corporate accountability will be thrown into disarray." David S. Ruder, Speech to the American Bar Association committee responsible for the Revised Model Business Corporation Act (Aug. 6, 1990), *in ABA Model Act Panel Rejects Other-Constituencies Measures*, 22 Sec. Reg. & L. Rep. (BNA) No. 33, ¶ 1217 (Aug. 17, 1990).

187. Directors' duty legislation affords no guidance on how directors should consider nonshareholder constituencies. *See* Dennis J. Block & Yvette Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44, 69 (1983); Matheson & Olson, *supra* note 6, at 1538-45.

188. The issue thus becomes whether director duties statutes constitute an efficient and desirable way to provide protections for nonshareholder groups. The Committee has concluded that permitting—much less requiring—directors to consider these interests without relating such consideration in an appropriate fashion to shareholder welfare (as the Delaware courts have done) would conflict with directors' responsibility to shareholders and could undermine the effectiveness of the system that has made the corporation an efficient device for the creation of jobs and wealth.

> The Committee believes that the better interpretation of these statutes, and one that avoids such consequences, is that they confirm what the common law has been: directors may take into account the interests of other constituencies *but only as and to the extent that the directors are acting in the best interests, long as well as short term, of the shareholders and the corporation. . . .*
>
> The confusion of directors in trying to comply with such statutes,

II. ESCALATING TENSIONS AND THE PATHWAY TO REFORM

Proxy contests, shareholder proposals, derivative suits, independent directors and a panoply of other remedial efforts have failed to assuage aggressive and increasingly expert institutional investors seeking to increase their voice in corporate governance. Why are institutional investors declaring war against the current governance regime? This movement has many facets and components. First, as noted above, the current anti-shareholder landscape embraced by management and legislators eager to maintain the corporate status quo has inhibited shareholder involvement. Second, institutional shareholders quite sincerely seek to maximize the value of their shares but find the current regime less than sympathetic to this goal.

The current anti-shareholder terrain inhibits shareholders from flexing their ownership muscle and reduces their incentives to invest the time and effort needed to contribute meaningfully to the longterm health of the corporation. This is an exceptionally costly development. A *sine qua non* for resolving the shareholder/nonshareholder tension, therefore, is a mechanism for harnessing valuable shareholder input on longterm corporate profitability.

A. THE ASCENDANCY OF THE INSTITUTIONAL INVESTOR

1. The Phenomenal Rise of the Institutional Shareholder

The past decade witnessed a staggering rise of institutional share ownership with an equally dramatic increase in the concentration of shareholdings. Numerous factors have interacted and coalesced to compel institutional shareholders to expand their active involvement in corporate governance issues. Among these are the increased size and concentration of investments by institutional shareholders, their enhanced sophistication, and the marked down-turn in takeovers as a means of monitoring and disciplining management.

By 1988, institutional assets had exploded to five trillion

> if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. . . . When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.

Other Constituencies, *supra* note 178, at 2268-69 (emphasis added).

dollars, or 18.7% of total financial assets in the United States.[189] In 1989, institutions held forty-three percent of all equities and fifty percent of the fifty largest companies' equity.[190] The fifty largest institutions owned $925 billion in stocks, or twenty-seven percent of the stock market.[191] By 1990, institutional investors owned forty-five percent of outstanding corporate equity.[192] By the end of 1990, institutional share ownership swelled to fifty-three percent.[193]

Pension funds, the largest class of institutional investors, owned roughly forty-four percent of all institutional holdings in 1987.[194] Controlling more than $2.5 trillion in assets, pension funds alone currently own more than twenty-five percent of all publicly traded equity in U.S. companies.[195] This percentage is very significant inasmuch as a recent study notes that stocks held in pension fund portfolios are held on average for two and one-half years.[196]

Investments in common stock by state and local pension systems ballooned from $10.1 billion in 1970 to $150.2 billion in 1986 and to an estimated $240 billion in institutional holdings in 1990.[197] Although the equity holdings of private pension funds have been relatively stable since 1982,[198] state and local government pension holdings have increased markedly, to a total of $223.7 billion in stocks in 1988, equivalent to 9.1% of the New York Stock Exchange's (NYSE's) total market value.[199]

The primary impetus for increased shareholder activism likely stems from increased ownership concentration.[200] Voting power is increasingly concentrated among a small number of major institutions. Increasingly concentrated share ownership drives institutional activism in two ways. First, institutions

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189. Clifford L. Whitewall, *Institutional Ownership*, *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 75, 79. In contrast, institutional assets amounted to $107 billion or 8.4% of the total United States financial assets.

190. Brancato, *supra* note 3, at 406-07.

191. *See The Institutional Investor 300: Ranking America's Top Money Managers*, *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 137, 173. Percentages are based on the Wilshire 5000 Index.

192. Koppes & Gillan, *supra* note 8, at 29.

193. Black, *supra* note 8, at 827.

194. Koppes & Gillan, *supra* note 8, at 29.

195. *Id.*

196. *See* James A. Waite, *Pension Funds Try to Retire the Idea that They Are Villains*, WALL ST. J., Mar. 20, 1990, at C1.

197. Whitewall, *supra* note 189, at 79.

198. *Id.* at 80.

199. *Id.*

200. July 1990 Client Advisory Letter, *supra* note 9, at 34.

which own a large stake in a corporation are less able to sell their shares and take the "Wall Street walk."[201] As James Martin of one institutional fund, the College Requirement and Equities Fund, attests, "we're the quintessential long-term investors."[202] Second, a greater stake means a greater incentive to invest time and resources toward improving corporate monitoring and performance.

Major shareholders thus have begun to unite toward more effectively wielding their immense power. The Council of Institutional Investors serves as a nucleus for institutional activism.[203] Institutional Shareholder Services advises large institutional investors on corporate governance issues.[204] Analysis Group provides economic and financial consulting services to institutional investors.[205] Analysis Group has created the Institutional Voting Research Service to evaluate the governance and economic performance of large corporations.

Institutional shareholders may become a powerful lobbying force. Although institutions failed to defeat antitakeover legislation recently enacted in Pennsylvania and Massachusetts, they succeeded in modifying the laws to allow for opt out clauses.[206]

2. Current Governance Initiatives by Major Shareholders

As noted above,[207] institutions with a large proportion of shares and a relatively high concentration of a small number of players have become increasingly active.[208] One important development in this shareholder activism is the institutions' involvement in proxy contests. Proxy solicitors, dissidents, and

201. *See* Matheson & Olson, *supra* note 6, at 1477-79.

202. David Pauly, *Wall Street's New Musclemen*, NEWSWEEK, June 5, 1989, at 46, 46.

203. Robert D. Rosenbaum & Michael E. Korens, *Trends in Institutional Shareholder Activism: What the Institutions are Doing Today, in* INSTITUTIONAL INVESTORS, *supra* note 3, at 45, 48. The Council of Institutional Investors has adopted a shareholder "bill of rights" to enhance the shareholders' role in making corporate management more accountable. *See* David A. Vise, *"Bill of Rights" Seeks to Boost Power of Shareholders*, WASH. POST, Apr. 13, 1986, at F1.

204. Rosenblum & Korens, *supra* note 203, at 48.

205. *Id.*

206. For Pennsylvania, see *Controversial Pa. Bill Would Make Takeovers More Difficult*, 22 Sec. & Reg. L. Rep. (BNA) No. 13, at 474 (1990). For Massachusetts, see Hillary Durgin, *Massachusetts Enters Takeover Fray: Bill Would Mandate Classified Boards*, PENSIONS & INVESTMENT AGE, Apr. 16, 1990, at 1.

207. *See supra* part II.A.1.

208. *See* Conard, *supra* note 13, at 132-33.

corporations understand that institutional investors "now hold the key to most important proxy initiatives," and have thereby placed increased emphasis on influencing institutions.[209] Over the long term, such proxy challenges may result in negotiated settlements, thus moving toward a longterm working partnership.[210]

An increasing number of shareholder proposals also have received substantial and sometimes majority support. For example, six major companies, Armco, Avon, Champion International, K-Mart, Lockheed, and Ryder System, adopted proposals to redeem or require shareholder approval of poison pills.[211]

In 1989, institutional muscle expressed itself through 215 governance proposals. As of August, 285 governance proposals had surfaced in 1990.[212] Votes in favor of these proposals reached new highs: support for poison pills averaged twenty-nine percent of outstanding shares (36.7% of votes cast); votes for confidential voting averaged 23.6% of outstanding shares (30.3% of votes cast); votes for opting out of the Delaware takeover statute averaged 31.9% of outstanding shares (38.9% of votes cast); and votes in favor of eliminating "golden parachutes" averaged eighteen percent of outstanding shares (24.3% of votes cast).[213]

One new type of initiative, sponsored by the College Retirement Equities Fund, proposed limiting the ability of directors to place "significant" new blocks of voting stock absent prior shareholder approval. Placing such blocks of voting stock in friendly hands effectively grants boards veto power over unwanted takeover activity.[214] The most pervasive examples of these include Employee Stock Ownership Plans (ESOPs) and

209. May 1990 Client Advisory Letter, *supra* note 21, at 20.

210. *Id.* at 20.

211. *Id.* at 24.

212. *See* John J. Gavin, *Changes in Corporate Control and Governance Communicated Through Proxy Power*, *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 91, 96.

213. *See* American Society of Corporate Secretaries, Inc., Letter to Ms. Linda C. Quinn, *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 193, 200. Responding to this expanding institutional might, corporations began either adopting these governance proposals "voluntarily" or negotiating with the instigating institutions. Analysis Group concluded that opposition groups achieved partial or complete victories in 78% of their attempts between September 1989 and May 1990. *See* Gavin, *supra* note 212, at 97.

214. *See* May 1990 Client Advisory Letter, *supra* note 21, at 23-24.

strategic block placements.[215]

These shareholder initiatives are evidence of two important facts. First, they reflect the desire of institutional investors to voice their say on significant corporate policy matters. The breadth of the proposals and the increasing significance of the vote in favor of such proposals show that the strength of this desire is a continuing phenomenon. Today's institutional shareholders, taking the lead for shareholders as a group, appear to desire to be involved in and consulted on a broader variety of corporate issues.

Second, the shareholder proposal process is an imperfect mechanism for making shareholder feelings known. The problem is the lack of an effective process in which these shareholders can be more actively involved. Similarly, corporate directors have no incentive to seek such input. Consequently, shareholders are locked out of the decision-making process on many issues that affect the value of their shares, the future course of the corporation, or both.

B. REFORMING GOVERNANCE BY IMPROVING THE BOARD OF DIRECTORS

In the past several decades, much reform has sought to alter board composition. Chief among these proposals have been reforms aimed at installing independent directors who, in theory, would be free of the conflicts of interest that affect management executives.

Courts have stressed the importance of outside directors providing objective oversight and reasoned business judgment.[216] One group of corporate executives would recommend an "overwhelmingly outside board."[217] The Council of Corporate Law Section of the Delaware Bar Association also stresses the central role of outside directors.[218] The Business Roundtable advises that outside directors should constitute no less

215. *Id.* at 24.

216. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985); Unocal v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985); *cf.* Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d. 173, 177 n.3 (Del. 1986).

217. JEREMY BACON & JAMES K. BROWN, THE CONFERENCE BOARD, CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD 62-63 (1973). The Conference Board is an association of executives of large corporations. *See* Conard, *supra* note 13, at 129 n.40.

218. *See* E. Norman Veasey & Jesse A. Finkelstein, *New Delaware Statute Allows Limits on Director Liability and Modernizes Indemnification Protection*, BUS. LAW. UPDATE, July-Aug. 1986, at 1-2.

than a "critical mass."[219] The *Corporate Director's Guidebook* of the American Bar Association recommends that certain committees of the board be composed exclusively of "nonmanagement" directors.[220] Since its inception, the American Law Institute's Corporate Governance Project (ALI Project) has recommended that large public corporations have specified proportions of independent directors who are "free of any significant relationships with the corporation's senior executives."[221]

The proposals for reforming the nature and composition of the board vary significantly with the proponent. For example, institutional investors recently filed proxy resolutions with numerous firms demanding that a majority of directors be independent of management.[222] Louis Lowenstein would allow shareholders to control a few directorships.[223] Two interesting reform proposals advanced this decade seek to elevate the board to a position *non plus ultra*. Lipton and Rosenblum's proposal would grant boards a five-year life span that could be cut short only by board conduct of the most egregious ilk.[224] Gilson and Kraakman's proposal would reinvent the outside director by proposing that corporations adopt an institutional investor-sponsored "core" of "professional" directors whose

219. Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, *reprinted in* 33 BUS. LAW. 2083, 2108 (1978) [hereinafter Business Roundtable 1978].

220. COMMITTEE ON CORPORATE LAWS, ABA, CORPORATE DIRECTOR'S GUIDEBOOK, *reprinted in* 33 BUS. LAW. 1591, 1625-27 (1978) (discussing the composition of the nominating, compensation, and audit committees).

221. Proposed Final Draft, *supra* note 14, § 3A.01 (cross-references omitted). The first draft required that large, publicly held corporations have boards with a majority of such directors. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03 (Tentative Draft No. 1) (1982). In 1984, this requirement was changed to a "recommendation of [good] corporate practice." AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 3.04 (Tentative Draft No. 2) (1984).

222. Hillary Durgin, *Fighting For Independence*, PENSIONS & INVESTMENTS, Feb. 18, 1991, at 1, 1 (noting that the issue of insider boards is at the top of the corporate governance agenda). Similarly, in an effort to garner support in its proxy fight with Carl Icahn, Texaco's management agreed to select one board member from a slate of directors provided by CalPERS. James Flanigan, *Texaco Stresses the "Share" in "Shareholders,"* L.A. TIMES, Jan. 25, 1989, pt. IV, at 1.

223. LOWENSTEIN, *supra* note 77, at 205-18.

224. Lipton & Rosenblum, *supra* note 12, at 225-28. Scholars appear to have widely varied views about how effective the Lipton/Rosenblum proposal is likely to be. *See, e.g., 'Intriguing, But . . .,' Observers Say in Response to Plan for Five-Year Terms, No-Holds-Barred Elections*, 6 Corp. Couns. Wkly. (BNA) No. 19, at 8 (May 8, 1991).

livelihood would depend primarily upon shareholder approbation.[225]

Although installing independent directors is an essential component of an optimal governance structure, improving the nature, character, and function of the board is but a first step in governance reform. Indeed, the facial "independence" of directors resolves only part of the conflict of interest between management and shareholders. Managers "can easily find directors who are neither subordinates, relatives, nor suppliers, who will support almost anything that the executives propose, and who will resign in extreme cases rather than oppose the executives who have invited them to the board."[226] One commentator suggests that rather than manage, boards react; they render advice when solicited and replace the chief executive officer only in dire emergencies.[227]

Even with nominating committees composed of independent directors, management continues to influence the selection of directors. Management typically can veto candidates. In addition, outside directors, aware of the ability of management to influence the composition of the board, naturally tend to mesh their decision making with that of management.[228] One oft-cited example of independent outside directors' inability to constrain self-interested behavior is the use of "Special Litigation Committees," consisting of independent directors, to determine whether corporations should consummate a shareholder derivative suit against their officers or directors. One study noted that "although there have been more than a score of special litigation committee cases . . . in all but one the committee concluded that the suit in question was not in the corporation's best interest."[229]

Moreover, even totally independent directors are faced today with two significant problems that cloud their judgment. First, the recent development of the multi-constituency concept

225. *See* Gilson & Kraakman, *supra* note 12, at 883-92.

226. Conard, *supra* note 13, at 129 (citing James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83); *see* M. SOSNOFF, SILENT INVESTOR, SILENT LOSER 170-74, 182-83 (1986).

227. MYLES L. MACE, DIRECTORS, MYTH AND REALITY 178-90 (1971).

228. "All too often . . . [independent directors] turn out to be more independent of shareholders than they are of management." Gilson & Kraakman, *supra* note 12, at 873.

229. James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 963.

leaves directors flailing when faced with an issue that potentially has a different impact on different constituencies. How do they balance these tradeoffs? It is unclear to whom, if anyone, these directors owe their primary allegiance.

Second, under current statutes and case law, the directors rarely have the opportunity or the incentive to obtain the input of the shareholders on even the most fundamental governance issues. The modern corporate framework envisions that directors, not shareholders, typically make policy decisions. Given this current setup, directors can hardly suggest calling a shareholder meeting. Shareholder input is not required and therefore does not factor significantly into the decision-making process.

C. Reforming Governance by Improving the Proxy System

Many commentators acknowledge that proxy voting as currently constituted is not an ideal system for expressing shareholder sentiment. Koppes and Gillan liken proxy contests to "beauty contests," stressing that, while resort to a challenge through a proxy contest may be appropriate in certain limited circumstances, the exorbitant costs and adversarial nature of proxy contests "often threaten to destroy a company rather than benefit it."[230]

Shortcomings in the current proxy system abound. Large shareholders typically avoid openly opposing management.[231] In addition, the formidable advantages that incumbents enjoy permit boards sympathetic to current management to retain control almost without limit.[232] Moreover, a corporation's cost of subsidizing numerous proxy fights could be substantial.[233] Finally, from a regulatory standpoint, the SEC has a surprisingly limited ability to intrude into state jurisdiction over corporate governance and shareholder voting rights.[234]

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230. Koppes & Gillan, *supra* note 8, at 30 ("[R]ecent proxy challenges have appeared to disintegrate into 'beauty contests'—mere competition between clever 'sound bites.' ").

231. *See* Dent, *supra* note 14, at 903-05. Shareholders "tend to vote for management because assertive shareholders encounter management hostility. Managers can deny rebellious shareholders valuable information." *Id.* at 904 (footnote omitted).

232. *See id.* at 903.

233. *Id.* at 908.

234. James Lyons, *States' Rights vs. Shareholders' Rights*, FORBES, Sept. 17, 1990, at 56, 56.

Proposals for modifying the system vary greatly. People with viewpoints as diverse as Victor Brudney and Martin Lipton would grant shareholders with large holdings access to corporate funds for proxy solicitations.[235] Professor Dent "proposes to unite ownership and control by transferring control of proxy solicitations to a committee of a corporation's largest shareholders."[236] Dent would grant exclusive access to the corporate treasury for proxy solicitations to a committee of the ten or twenty largest shareholders of the corporation.[237] Professor Eisenberg would grant shareholders collectively holding more than five percent of a firm's stock the ability to nominate directors in the firm's proxy statement.[238] The authors of this Article believe that these proposals have merit and deserve study for implementation in connection with the proposals made herein.[239]

As part of its review of federal proxy rules, in June, 1991, the SEC proposed changes under the Securities Exchange Act.[240] These proposed changes would make it easier for large shareholders to communicate among themselves by exempting them, in some situations, from making proxy statement filings

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235. Victor Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 284-85 (1966); Lipton, *Corporate Governance*, *supra* note 6, at 67-69.

236. Dent, *supra* note 14, at 882.

237. *Id.* at 907.

238. EISENBERG, *supra* note 38, at 117.

239. Other forms of institutional-shareholder involvement include informal agreements to communicate and the creation of "restructuring" funds which combine the resources of several investors for the purpose of taking a large, influential ownership interest in companies. *See* Koppes & Gillan, *supra* note 8, at 30. Koppes and Gillan stress that such informal, one-to-one channels of communication are appropriate "[w]hen a shareholder has a specific concern regarding a specific major investment . . . ." *Id.* They say "these efforts can be successful only on an 'ad hoc' basis; no shareholder, not even one as large as CalPERS . . . has the resources necessary to seek and participate individually in meetings with every company that may be performing below expectations." *Id.*

"Restructuring" funds often retain business experts to assist the target companies improve performance. *Id.* Koppes and Gillan suggest, however, that these "restructuring" funds have limited use due to their potential for abuse. "When used as an antitakeover device, this mechanism can thwart positive, constructive change in favor of maintenance of the status quo." *Id.* Their costliness is also a factor. *Id.* ("[T]he universe of American corporations is simply too large to make this a viable model for shareholder/corporation communications in any but the smallest, or poorest performing, or most vulnerable, institutional holdings.").

240. *See SEC Proposes Changes to Facilitate Communications Among Shareholders, Including Eased Filing Requirements*, 6 Corp. Couns. Wkly. (BNA) No. 25, at 8 (June 19, 1991).

even if they communicate with more than ten shareholders in the company;[241] eliminate the requirement that shareholders contesting a proxy issue submit "preliminary" documents to the SEC;[242] and facilitate access to shareholder lists.[243] Such proposals, if adopted, would help shareholders communicate on corporate matters.[244] Still, proxy rules are not an ideal solution. As one commentator stated:

> [I]n many ways, the proxy rules discourage responsible, long-term investors from playing a meaningful role in the governance of public corporations. The proxy rules in their present form have evolved in and been shaped by an environment that reflects an underlying philosophy of protecting registrants from shareholder involvement . . . . [T]he current rules . . . are an impediment to better corporate governance to the extent that they suffocate shareholder input or insulate management.[245]

D. THE ALI PROJECT

The ALI Project, formally initiated in 1978, towers above other proposals in its exhaustive treatment of governance reform. The ALI Project intends to cover only those parts of corporate law relating to corporate governance and, indeed, "only the most important aspects of corporate governance."[246] The ALI Project's recommendations on corporate governance include not only issues governed by state legislation, but also issues relating to the general practice of corporations and the management of corporate affairs.[247]

A cornerstone of the ALI Project is the monitoring model of corporate governance pioneered by Professor Melvin Eisen-

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241. The proposed changes would exempt "disinterested" shareholders from the proxy statement requirement. *Id.* "Disinterested shareholders" are persons who have no financial interest either in the company (aside from being a shareholder) or in the outcome of a proxy issue such as a proposed recapitalization or merger. *Id.* "The purpose of the proposed amendment would be to allow shareholders to tell other shareholders they were dissatisfied or objected to management and other proposals without fearing they would become subject to SEC proxy rules." *Id.*

242. Under the proposal, only the "definitive" or final form of advertisements, letters, and related documents need be filed with the SEC. *Id.*

243. *Id.*

244. *See* Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. CORP. L. (forthcoming 1992).

245. Robert A.G. Monks, *The Current Legal Environment and Proposals for Reform*, *in* INSTITUTIONAL INVESTORS, *supra* note 3, at 155, 157 (reprinting CalPERS' submission to the SEC, dated November 3, 1989, requesting that the SEC undertake a review of the proxy system).

246. Eisenberg, *supra* note 4, at 498.

247. Goldstein, *supra* note 80, at 507.

berg, the Project's chief reporter,[248] in which independent outside directors' primary function is to oversee or monitor management.[249] The ALI recommends that "[t]he board of every large publicly held corporation . . . have a majority of directors who are free of any significant relationship with the corporation's senior executives."[250] The ALI also recommends that corporations implement independent audit committees,[251] independent nominating committees,[252] and independent compensation committees.[253]

Complementing this monitoring model, the ALI Project endorses a "command model" of corporate governance to stimulate directors by threat of sanction.[254] Although fiduciary duties function effectively in the context of well-defined activities, they are less effective when discretion predominates.[255] However, the limited circumstances under which directors might be personally liable makes this approach somewhat unrealistic.[256]

Recognizing that indemnification and insurance may serve

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248. *See* Dent, *supra* note 14, at 896.

249. EISENBERG, *supra* note 38, at 162-68.

250. Proposed Final Draft, *supra* note 14, § 3A.01 (cross-references omitted).

> A 1991 study by Korn/Ferry reported that the boards of responding corporations had an average number of three inside and nine outside directors. In 1985, Korn/Ferry had found that the comparable average was ten outside directors and four inside directors; in 1975, the average had been eight outside directors and five inside directors. The 1990 Korn/Ferry study predicts that in the next decade, the number of insiders on the board will drop even further, from three to two, and that increasingly the only insiders on the board will be the chief executive officer and the chief operating officer.

Id. § 3A.01 reporter's note 3 (citations omitted).

251. *Id.* § 3A.02.

252. *Id.* § 3A.04.

253. *Id.* § 3A.05. Unfortunately, even the Project's defenders submit that its proposals will have only slight impact on corporate governance. Indeed, Professor Eisenberg concedes that the monitoring model will make an important difference only "in the 100th or 200th or 300th case." Melvin A. Eisenberg, *Conference Panel Discussion: Federalism Issues in Corporate Governance*, 45 OHIO ST. L.J. 591, 598 (1984).

254. Dent, *supra* note 14, at 901.

255. *Id.*

256. "The search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968); *see also* Weiss, *supra* note 14, at 15 ("Only in instances where directors have come close to abdicating totally will the ALI's proposals make imposition of liability somewhat more likely." (footnote omitted)).

to neutralize the benefits of imposing sanctions upon directors, the ALI proposes to limit these protections.[257] This approach runs counter to the almost universal trend toward indemnification, exculpation, and insurance.[258] In any event, legislatures are unlikely to reverse themselves on these issues.

E. Shareholder Advisory Committees and the Seeds of Longterm Shareholder Involvement

Reformers have also sought to identify or create alternative channels of involvement in corporate governance. For institutional investors to comply with their own fiduciary duties to invest prudently, they must have the information necessary to evaluate the performance of the directors to whom they have delegated managerial responsibility.[259] A recently proposed mechanism by which shareholders seek to discuss governance issues with management and the board is the shareholder advisory committee.[260]

Shareholder advisory committees are not a new concept.[261] The powerful CalPERS Fund proposed such committees for Avon Products, Inc.; Texaco, Inc.; and Sears, Roebuck & Co., in which the Fund had significant holdings.[262] Howard Sherman of Institutional Shareholder Services views CalPERS' current

257. *See* Proposed Final Draft, *supra* note 14, § 7.20(b) & cmt. h (setting forth limitations on indemnification).

258. *See* Conard, *supra* note 13, at 129-30 (discussing an extension of the business judgment rule that presumes that conflict-of-interest transactions are valid when independent directors approve them).

259. Koppes & Gillan, *supra* note 8, at 30; *see also* David G. Ball, *The Inevitability of Getting Involved*, 15 Directors & Boards, Winter 1991, at 56, 56 (noting that ERISA requires plan fiduciaries to vote knowledgeably).

260. Shareholder advisory committees are proper subjects for shareholder proposals under rulings. *See* Rock, *supra* note 13, at 491 n.178 (citing, for example, TRW, Inc., SEC No-Action Letter, Feb. 12, 1990, *available in* Westlaw, FSEC-NAL file, 1990 WL 286008).

261. The contemporary form of these committees, however, differs from past versions:

> The idea [behind shareholder advisory committees] has considerable historical precedent. In earlier eras, free of regulations that deter the formation of outside shareholder groups . . . , shareholder committees were a relatively widespread phenomenon at public corporations. They were typically organized informally when corporate performance or board behavior was suspect, and convened to oversee and question the board. The current crop of shareholder committees propose a modern-day equivalent that is formal and internal to the corporation due to the deterrents that the regulations place on outside committees and groups.

May 1990 Client Advisory Letter, *supra* note 21, at 24.

262. Koppes & Gillan, *supra* note 8, at 30.

proposals to establish shareholder advisory committees as "the most important shareholder initiative attempting to influence shareholder-board relations."[263] During a proxy contest between Lockheed Corporation and one of its shareholders, the shareholder promised to establish a shareholder advisory committee if his director nominees were elected.[264] In 1989, a First Executive Corporation shareholder proposed that the board establish a seven-member shareholder advisory committee.[265]

Shareholder bankruptcy committees permitted under Chapter 11 of the Bankruptcy Code[266] serve as one possible model for corporate shareholder advisory committees.[267] A director often bears a responsibility to multiple constituencies creating a conflict of interest similar to that a corporation faces when it enters bankruptcy.[268] Such a conflict may prevent the director from adequately recognizing and representing shareholder interests in such situations as hostile takeover bids and derivative suits filed against officers or directors.[269]

263. Sherman, *supra* note 22, at 306.

264. Koppes & Gillan, *supra* note 8, at 30.

265. First Executive Proxy Statement, May 1, 1989, at 10-11 *available in* Westlaw, SEC-Online file.

266. 11 U.S.C. §§ 1101-1174 (1988).

267. Rock, *supra* note 13, at 492-93 n.188. The Bankruptcy Code provides that: "On request of a party in interest, the court may order the appointment of additional committees . . . of equity security holders if necessary to assure [their] adequate representation." 11 U.S.C. § 1102(a)(2) (1988). Furthermore, a "committee of equity security holders appointed under subsection (a)(2) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the kinds represented on such committee." *Id.* § 1102(b)(2).

Shareholder bankruptcy committees thus set out one possible paradigm for shareholder advisory committees. Rock, *supra* note 13, at 492-93. Under Chapter 11, these committees are given the duty and power to represent the equity security holders and may

> (1) consult with the trustee or debtor in possession concerning the administration of the case; (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor . . . ; (3) participate in the formulation of [reorganization] plan[s] . . . ; (4) request the appointment of a trustee or examiner . . . ; and (5) perform such other services as are in the interest of the equity security holders.

11 U.S.C. § 1103(c) (1988). The bankruptcy committee also has the power "with the court's approval . . . [to] select and authorize the employment . . . [of] attorneys, accountants, or other agents to represent or perform services for such committee." *Id.* § 1103(a).

268. Rock, *supra* note 13, at 493 ("When a corporation enters into a Chapter 11 reorganization, the board of directors faces a conflict among its duties and loyalties to its shareholders, officers, employees, creditors, and the court.").

269. *Id.* (In these circumstances, "directors may be ill-suited to represent the interests of shareholders.").

Since shareholder advisory committees are an untested, evolving concept, they have no definitive composition.[270] As CalPERS proposed to Avon, for example, a shareholder advisory committee would consist of at least nine members.[271] Under the proposal, the board would retain authority over the process of selecting committee members, provided that: each member owned at least 1,000 shares of stock and was affiliated with the corporation only as a shareholder and at least five members were selected from the fifty largest beneficial owners of the corporation's voting shares.[272] CalPERS further urged that each membership term be limited to one year, and that no member be eligible to serve more than three consecutive terms.[273] Finally, CalPERS proposed that Avon's shareholder advisory committee provide advice to the board "regarding the interests of shareholders on principal policy considerations relevant to the company and its business, such as major restructuring or acquisitions, mergers, compensation issues, and other matters on which the board may choose to consult the committee."[274]

Shareholder advisory committees can both serve as a resource to the board and enhance relationships between a corporation and its largest providers of capital.[275] These committees are designed to overcome one of the classic problems in shareholder governance participation: the free-rider problem. Generally, the free-rider problem focusses on incentives. Under this theory, no individual shareholder has incentive to take action that would benefit shareholders as a class since each shareholder knows that its efforts would be enjoyed by all. Thus, individual shareholders have an incentive to take no action under the assumption that another will, and thus expect to enjoy the benefits of the other's efforts.[276]

The shareholder advisory committee may provide a more efficient mechanism for investors with greater concentrations of share ownership to be involved in the governance process. With greater concentration, the potential benefits of providing

270. Koppes & Gillan, *supra* note 8, at 30-31.

271. *Id.* at 31.

272. *Id.*

273. *Id.* Such committees must be limited to providing non-binding, advisory counsel to the corporation's board, because the shareholders have delegated managerial responsibility to the elected directors. *Id.*

274. *Id.* at 31-32.

275. *Id.* at 32.

276. Sherman, *supra* note 22, at 306 n.8; Rock, *supra* note 13, at 456.

discipline increase while the corresponding costs decrease.[277] The magnitude of the enhanced benefits from this form of monitoring, however, depends on the role and function of the committee. For example, the benefits to a shareholder from a purely advisory committee, although potentially substantial, are expected to be less than those of a mandatory committee.[278] In addition, the costs of organizing, monitoring, and influencing management would correspondingly decrease since many costs would be reimbursed and the costs of small, officially recognized committees should be lower than the comparable costs for large groups or committees formed for a particular issue.[279]

For all the potential that such advisory committees may hold, their creation in all but the most extreme circumstances currently is unlikely. As with the creation of creditor and shareholder committees in the bankruptcy context, the corporation must experience significant problems before the intensity of the focus by institutional shareholders will force changes. Absent such extreme problems, it remains unlikely that institutional shareholders will focus their energies on creating shareholder advisory committees at any particular corporation.

III. TRANSCENDING THE DIALECTIC: THE LONGTERM SHAREHOLDER MODEL OF CORPORATE GOVERNANCE

The development of corporate governance regimes has focussed on extremes. Shareholder primacy, in its purest form, cannot withstand scrutiny. The modern corporation is far more than the sum of its shareholders.[280] On the other hand, the

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277. Rock, *supra* note 13, at 460.

278. If certain key decisions, such as whether the corporation should be sold or whether or not to pursue a derivative suit, were delegated to the committee, the committee would be likely to have a significant impact. If the committee were purely advisory, the increase . . . could still be substantial, because once the committee was in place, the managers of a concentrated corporation could only ignore the institutional shareholders' collective, organized advice at their peril.

Id. at 495.

279. *Id.* To the extent major shareholders are repeat players, "the likelihood is low that free riding will significantly undermine the shareholders' committees." *Id.* at 496.

280. As Lipton and Rosenblum have noted:

> The corporation affects the destinies of employees, communities, suppliers, and customers. All these constituencies contribute to, and have a stake in, the operation, success, and direction of the corporation. Moreover, the nation and the economy as a whole have a direct inter-

norm of longterm corporate welfare, in its modern form, eliminates the meaningful shareholder input that institutional shareholders have to offer.[281]

Institutional shareholders have been portrayed largely as short-term, passive owners.[282] Martin Lipton, one of the most outspoken critics of institutional shareholders' motivations, in an article with Steve Rosenblum, wrote:

> The ascendancy of the institutional stockholder . . . , however, creates an emphasis on short-term results that makes it increasingly difficult for the corporation to maintain the long-term focus necessary to its own and society's well-being. . . . The short-term bias imposed by institutional stockholders and takeover activity is real, and this short-term bias has substantial corporate and societal costs.[283]

Lipton and Rosenblum also note that the stockholder/managers of closely held, nonpublic corporations "have an interest in developing the corporation, nurturing its business, preserving its strength, and ensuring its future."[284] In contrast, "the stockholder/investors of the modern publicly held corporation view the corporation more as the holder of a betting slip views a racehorse."[285]

It is clear from the recent initiatives of major shareholders that the Lipton/Rosenblum assertion that institutional investors are inherently short term is overstated. Moreover, to the extent that the proposition is valid, the attitude of institutional

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> est in ensuring an environment that will allow the private corporation to maintain its longterm health and stability. Rules of corporate ownership and governance must take account of many more interests than do the rules governing less complex property.

Lipton & Rosenblum, *supra* note 12, at 192.

281. Even Lipton and Rosenblum concede that "stockholders deserve a prominent voice in corporate governance." *Id.* at 194.

282. *See* Gilson & Kraakman, *supra* note 12, at 863 ("An institution that trades stock frequently is considered a short-term shareholder without a stake in the future of the corporation."). Referring to a director's belief that the benefit of stock appreciation should go to the longterm shareholders as opposed to short-term speculators, Jay W. Lorsch noted the purported distinction between loyal shareholders and institutional investors:

> By shareholders, this director means the loyal investor who holds the company's shares for the longterm and, from the perspective of the directors, institutions are the least loyal shareholders. In fact, they have difficulty taking the institutional owner seriously, believing its goals are at odds with the corporation's longer-term interests and are too concerned with short-term gain.

JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 46-47 (1989).

283. Lipton & Rosenblum, *supra* note 12, at 203.

284. *Id.* at 194.

285. *Id.*

shareholders is partially the result of being locked out of the governance process. Contrary to the Lipton/Rosenblum claim, institutional investors today, because of their large holdings, offer the potential to resemble the nurturing owners of the closely held business. The challenge is to develop a model of corporate governance which provides major shareholders with an incentive to invest in a corporation much as shareholder/managers of a closely held corporation develop and nurture their enterprise for the long term.

Indeed, given the current governance framework, "[i]nstitutional stockholders have little incentive or inclination to behave like traditional owners in the classical economic model—that is, to work actively towards the long-term operating success of the corporation."[286] But straws are already in the wind. Several major institutions have proven longterm track records.[287] Institutions, in addition, are no longer merely pursuing one-time takeover premiums.[288] Institutions have, in many circumstances, changed from "corporate gadfl[ies] to corporate citizen[s]," whose substantial levels of ownership provide legitimate reasons for them to invest time and money in improving corporate monitoring and performance.[289] Indeed, Howard D. Sherman of Institutional Shareholder Services, Inc., notes that: "Most institutional shareholders, pension funds especially, have a *de facto* long-term planning horizon. Even if they do not own stock in a given company indefinitely, the pension funds' sheer size means that they can expect to reassume positions in the same company many times over, year after year."[290]

Similarly, Koppes and Gillan assert that "today's institutional investor is a long-term holder of equity; since large institutions cannot easily buy and sell huge blocks of stock without negatively affecting the value of their entire portfolios, institu-

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286. *Id.* at 205-06.

287. Gilson and Kraakman note that "[s]ome of the largest institutional investors today *are* longterm investors. For example, the annual turnover rate of [CalPERS] equity portfolio is approximately ten percent, and its average holding period for particular stocks is between six and ten years." Gilson & Kraakman, *supra* note 12, at 863.

288. July 1990 Client Advisory Letter, *supra* note 9, at 34.

289. *Id.*

290. Sherman, *supra* note 22, at 300 n.1; *see also* Lipton & Rosenblum, *supra* note 12, at 216-17 ("[T]he large institutional stockholder is a long-term investor in the market as a whole. Unless it divests itself of equities altogether it will have an equity stake in a substantial portfolio of corporations regardless of how long it maintains a stake in any one corporation.").

tions have become almost a permanent shareholder."[291]

A workable system of corporate governance for the modern publicly held corporation cannot embrace the "shareholder primacy" norm or the "longterm corporate welfare" norm to the exclusion of the other. Such an approach ignores the underlying currents now shaping the tensions among shareholders and nonshareholders, namely, that shareholders are able to focus meaningfully and aggressively on the long term once granted an incentive and legal basis to do so.

A mechanism is needed to transcend this dialectical framework. Shareholders and management share the same fundamental interest.[292] Over the long term, both demand sustained, solid growth and profitability. Properly harnessed, institutional capital will enable corporations to achieve exactly what they most desire, namely, the longterm growth also sought by investment funds.[293] A framework emphasizing the longterm shareholder should encourage shareholders and nonshareholders to develop a symbiotic relationship toward maximizing longterm profitability and competitiveness while minimizing the need for and possibility of hostile takeovers.[294]

Reform, therefore, must harness the best of both extremes of the dialectical development of corporate law. Like the shareholder primacy model, the operational focus must be the *shareholder*. Despite the growth and expansion of corporations and corporate interests, this group, the investors, remains the ultimate beneficiary of the corporation. Like the corporate welfare model, the focus must be on *longterm* performance. The typical modern corporation is not engaged in a short-term venture; it is a continuing enterprise and participant in a local (and often national or international) community.

Any legitimate reform proposal must combine these two objectives. The only way to maximize longterm corporate profitability—thereby optimizing social welfare—is to provide a structure and process for institutional shareholders as team

291. Koppes & Gillan, *supra* note 8, at 30.

292. *See* Lipton & Rosenblum, *supra* note 12, at 216 ("The long-term health of the business enterprise is ultimately in the best interests of stockholders, the corporation's other constituencies, and the economy as a whole.").

293. *See* Whitewall, *supra* note 189, at 85.

294. *See* Judith H. Dobrzynski, *Shareholders Unfurl Their Banner: 'Don't Tread On Us,'* BUS. WK., June 11, 1990, at 66, 67 ("If owners and managers can forge a new relationship—making shareholders' capital more patient in return for more say—the '90s could be a whole lot less contentious than the takeover-prone '80s.").

members with management to focus on longterm corporate performance. The process of corporate governance must encourage and reward the substantial role of institutional investors by giving them a greater voice in governance affairs and thereby creating an environment in which it is desirable to be a longterm shareholder.[295]

A. A PROCESS APPROACH TO GOVERNANCE REFORM

The central dilemma facing corporate law reformers has been aptly articulated by Professor Bernard Black. Professor Black notes that shareholder-driven attempts at corporate governance reform face insurmountable opposition in state legislatures from local incumbent management lobbies. Thus, any legislation that passes the legislative gauntlet reflects inevitable dilution and is essentially worthless. National reform is even more unlikely because proponents of corporate governance reform have to convince fifty legislatures to adopt these politically unpalatable proposals.[296]

To have a chance of successful adoption, a proposal for reform must be more than theoretically compelling. It must earn the respect of legislators, managers, and major shareholders. One of the greatest virtues of current state law is its flexibility. The benefits of mandatory manager constraining rules come at a cost of diminished flexibility. Thus, the optimal state law must be able to change as corporate needs change.[297] Reform efforts should balance this tension between mandatory law and flexibility.[298]

This tension has been at the heart of the theoretical "nexus of contracts" model of the corporation. The substantially mandatory nature of corporate law[299] has recently been the fo-

295. A longterm shareholder governance structure should accomplish several objectives. While establishing the groundwork for improving incentives, management accountability, director discretion, and shareholder communications, this governance structure should also preserve the ability of major outside shareholders to undertake value-increasing initiatives with the company. *See* May 1990 Client Advisory Letter, *supra* note 21, at 25.

296. Black, *supra* note 14, at 580.

297. *See id.* at 581 ("Before imposing minimum standards on corporations, we need to consider how those standards might be changed should they prove unwise, and to set up structures that facilitate change. Congressional paralysis today is such that Congress is a dangerous source for new rules.").

298. *See id.* at 593 (suggesting that reform efforts which fail to balance "mandatory law and inflexibility" are "doomed to failure").

299. *See* Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1396 (1989).

cus of growing scholarly debate.[300] Specifically, to what extent should the provisions of legislation regulating corporate governance be mandatory rather than suppletory? Although the question appears simple enough, no clear answer exists.[301]

The central concern of corporate law is to minimize the conflicts of interest stemming from the separation of ownership and control. As the potential for conflict of interest increases, the need for implementing procedural safeguards to minimize the potential ill effects of these conflicting interests correspondingly increases. Thus, for example, "[a] director or senior executive will normally not be deemed to have breached the obligation of fair dealing if fair procedures for approval, following disclosure, are observed . . . ."[302]

Economic and legal scholars often focus upon free choice and an economic structure of corporate law[303] in which the corporation is viewed as a complex set of explicit and implicit contracts.[304] Accordingly, these scholars view corporate law as a

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300. *Id.* at 1396; *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 14.3, at 372 (3d ed. 1986) (arguing that the contract analogy breaks down with regard to involuntary creditors of a corporation); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983) (advocating the allowance of insider trading in publicly held corporations); Easterbrook & Fischel, *supra* note 52, at 427 (concluding that federal regulation of shareholders' voting, as opposed to common law rules, imposes costs in excess of any benefits); Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 6, at 715 (arguing against mandatory sharing of gains in corporate control transactions because unequal division of gains maximizes investor welfare); Fischel, *The Corporate Governance Movement*, *supra* note 14, at 1265 (disputing the corporate governance movement's premise that a systemic governance problem exists).

301. The contractual theory of the corporation is inadequate:

> [T]he nature and significance of [the 'nexus of contracts' revolution] remain obscure because, in some sense, the revolution has simply replaced one legal metaphor, the trust, with another legal metaphor, the nexus of contracts. Unfortunately, the legal drapery of both trust and contract ill fits the corporate body. Each metaphor distracts in different ways from the intractable problems with which the law must deal.

Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1449 (1989). For an excellent collection of articles on the debate, see generally Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

302. Proposed Final Draft, *supra* note 14, § 5.01 cmt. c.

303. As two commentators have noted: "What is open to free choice is far more important to the daily operation of the firm, and investors' welfare, than is what the law prescribes." Easterbrook & Fischel, *supra* note 62, at 1418.

304. "[T]he corporate structure is a set of contracts through which managers . . . exercise a great deal of discretion that is 'reviewed' by interactions with other self-interested actors." *Id.* at 1418.

means of enabling contract participants to adopt optimal contractual terms while opting out of suboptimal arrangements given the extremely varied risks and opportunities which inhere in our dynamic marketplace. "No one set of terms will be best for all . . . ."[305]

Currently, however, corporate law fails to recognize the critical value of longterm shareholder input amidst increasing conflicts of interest between shareholders and nonshareholders. If shareholders are a prime (if not the primary) constituency of the corporation, why not allow them to create their own corporate law?[306]

Optimally, then, and consistent with the "nexus of contracts" model, reform should focus primarily on how governance terms are approved and amended rather than on articulating substantive terms. This both reduces the risk that legislators will impose inefficient governance rules and reduces the need for substantive discretion-limiting rules.[307] Thus, a governance framework should set out standards for shareholders to approve major corporate actions while restricting managers' ability to control shareholders' agendas.[308]

This Article's proposal therefore emphasizes the *process* by which substantive rules are adopted or amended and de-emphasizes the specification of new substantive rules. It articulates a set of approval mechanisms and defines those fundamental transactions in which these approval mechanisms engage. Essentially, the proposal enhances the role of shareholders by providing them a place in the *process* by which fundamental corporate governance parameters are enacted or modified.

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305. *Id.*

306. *See* Black, *supra* note 14, at 582 (arguing that for larger public companies, reform of governance should focus on the process of change rather than substantive rules).

307. *Id.* at 583 ("If the change governing rules work well, managers will have less ability to use the charter amendment process or the state legislative process to alter the manager/shareholder contract, and also less incentive to try.").

308. *Id.* at 582; *see also* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621-22 (1989) (arguing for judicial oversight as a necessary complement to contractual freedom); *cf.* Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 753-54 (1987) (proposing federal law requiring that state laws "entailing a major change in relations between shareholders and managers . . . contain opt-in rather than opt-out provisions").

B. A Procedural Governance Framework

Consistent with this "process approach," a procedural governance framework must set out those circumstances and transactions needing shareholder input. This framework outlines the powers and duties of the board and the rights and powers of shareholders. Approval requirements should be proportionate to the level of conflict of interest and the degree to which a transaction fundamentally affects longterm shareholders' financial interests.

This proposal adopts the following governance concepts:[309]

(1) The ultimate objective of the corporation should be the maximization of longterm shareholder value and welfare.
(2) For the most part, directors are well suited to direct and monitor management toward maximizing longterm shareholder value.
(3) Directors and managers require substantial discretion to enable them to operate the corporation creatively and flexibly. Therefore, managerial discretion should be encouraged by the business judgment rule.
(4) Managers' and directors' interests sometimes diverge from and conflict with shareholders' interests.
(5) Longterm shareholders are well suited to guide directors with regard to potential conflicts of interest and fundamental corporate governance matters affecting their financial interests. In such circumstances, longterm shareholders should be afforded a mechanism enabling them to offer guidance.
(6) Directors and managers should be allowed to consider nonshareholder interests to the extent such consideration does not substantially compromise shareholders' interests.

The proposed governance framework seeks to balance the interests of shareholders and nonshareholders while granting directors enhanced guidance. Shareholders have a right to participate meaningfully in the fundamental financial decisions affecting corporate performance and growth, and longterm corporate health and competitiveness. The provisions for shareholder input suggested below are limited to conflict situations and specific financial decisions which are likely to have a material effect on longterm shareholders. These provisions are not intended to affect operational decisions best left to management.

The proposed model legislation seeks to provide a statutory corporate governance framework which induces shareholders to invest in corporations for the long term. At a minimum, the use of "long term" seeks to underscore the concept of meaning-

309. *See generally supra* note 18 (listing Elliott Weiss's seven fundamental principles of corporate governance).

ful shareholder involvement. Corporate management should be responsive to those major shareholders with proven track records and shareholders otherwise likely to contribute meaningfully to the corporation's underlying profitability and competitiveness, regardless of any time horizon. Put simply, this framework recognizes that directors will benefit from the meaningful input of sophisticated investors who genuinely seek to maximize underlying corporate welfare.

PROPOSED LEGISLATION

1. Powers and Duties of the Board

1.01 Authority of the Board

A corporation shall be managed by or under the direction of a board of directors[310] for the purpose of advancing the interests of the corporation and its longterm shareholders.

1.02 Standard of Conduct

A director shall discharge the duties of the position of director in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.[311]

A director shall, in considering the best interests of the corporation, place primary emphasis on the interests of longterm shareholders.[312] In considering the best interests of the corporation, a director

310. *See* DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation . . . shall be managed by or under the direction of [the board] . . . ."); REVISED MODEL BUSINESS ACT § 8.01(b) (1984); *cf.* Proposed Final Draft, *supra* note 14, § 3.01 ("The management of the business of a . . . corporation . . . should be conducted by or under the supervision of such principal senior executives . . . as are designated by the board." (cross-references omitted)).

We have drafted these provisions broadly to apply to corporations generally. Although we believe that many of these provisions are appropriate for all corporations, a legislature may choose to limit their application to certain types of corporations, such as publicly held corporations.

311. *See* REVISED MODEL BUSINESS CORPORATION ACT § 8.30(a) (1984); Proposed Final Draft, *supra* note 14, § 4.01(a).

> A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

Proposed Final Draft, *supra* note 14, § 4.01(a).

312. While we recognize that this standard is somewhat malleable, it serves to highlight that directors, exercising their business judgment, should place shareholder interests as primary. Such a recognition helps to cover a director's general obligations in making policy for the corporation and dovetails with the specific rights of shareholders to have a voice in certain transactions,

may consider the interests of nonshareholder constituencies only to the extent such consideration will not substantially compromise the best interests of the longterm shareholders.[313]

1.03 Shareholder Input

A. Fundamental Changes in the Corporation's Structure or Governance Regime

No corporation shall directly or indirectly effect a fundamental change in the corporation's structure or governance regime without prior shareholder approval, whether or not such approval is otherwise required pursuant to this statute.

Examples of such circumstances include but are not limited to:

1. Amendment of the articles of incorporation;
2. Adoption or abandonment[314] of a plan of merger or exchange including the merger of a subsidiary of the corporation with or into another entity, where the assets of the surviving entity exceed twenty percent of the assets of the corporation immediately prior to the transaction;[315]
3. Adoption or abandonment of a transfer[316] of all or substan-

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as specified in § 1.03 of this proposal. As Louis Lowenstein, head of Columbia University's Institutional Investors Project has noted, shareholders should hold the primary position " '[n]ot because you like them or hold them in high esteem but because if you don't there is no bottom line, no way to measure efficiency. . . . The system collapses . . . if shareholder interests are not primary.' " Leslie Eaton, *Corporate Couch Potatoes: The Awful Truth About Boards of Directors*, BARRON'S, Dec. 24, 1990, at 22 (quoting Louis Lowenstein).

313. Acknowledging the interests of nonshareholder constituencies takes the model of the corporation as a nexus of contracts into consideration. The scope of nonshareholder constituencies might be unspecified, as here and in some state enactments, or be specified to include only certain constituencies, such as employees, customers, creditors, and suppliers. *See* Matheson & Olson, *supra* note 6, at 1538-45 (analyzing constituency statutes). Given the other aspects of our framework and the necessity that directors give primary consideration to longterm shareholder interests, we prefer to omit the designation of particular constituencies.

314. Most, if not all, corporate statutes require shareholder approval for adoption of fundamental transactions, such as merger, transfer of assets, and dissolution, but *do not* necessarily require shareholder approval for *abandonment* of such actions. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c), (d) (1991). We believe that abandonment of such transactions often fundamentally affects the corporate governance regime and, accordingly, should also require shareholder approval.

315. The purpose of this last clause is to include triangular and reverse triangular mergers in which the assets being acquired will be a significant portion of the resulting consolidated entity. The 20% figure parallels a similar threshold in straight merger situations, in which shareholder approval is not required if the shares of corporate stock outstanding after the transaction will not exceed the shares outstanding immediately prior to the transaction. *Id.* § 251(f).

316. This term should be read broadly to include a sale and an exchange or lease of the corporation's assets.

tially all of the corporation's assets not in the usual and regular course of its business, including the pledge of corporate assets which would have a material effect on shareholder value or a sale of assets that would leave the corporation without a significant continuing business;[317]

4. Adoption or abandonment of corporate dissolution proceedings;[318]
5. Determination of whether to approve an acquisition of shares which would make the acquiror subject to the provisions of a business combination statute or other statutory provision which discriminates against an acquisition of shares that is not accompanied by board of directors approval;[319]
6. Determination of whether to adopt or redeem a shareholder rights plan or its equivalent, or amend or waive any provision of such a plan;[320]
7. Determination of whether to issue debt likely to cause other of the corporation's debt obligations to be downgraded;[321]
8. Any issuance of securities by the corporation with distribution or liquidation rights and preferences prior or superior to outstanding shares;[322]
9. Any issuance of securities with voting rights that are superior

317. *See* Shareholder Bill of Rights, *reprinted in* Roland M. Machold, *The American Corporation and the Institutional Investor: Are There Lessons From Abroad?*, 1988 COLUM. BUS. L. REV. 751, 760 (requiring shareholder approval for decisions which would "[p]ermit the sale or pledge of corporate assets which would have a material effect on shareholder values").

318. *See, e.g.*, DEL. CODE ANN. tit. 8 § 275 (1991); REVISED MODEL BUSINESS CORPORATION ACT § 14.02(b), (e) (1984) (requiring approval of dissolution "by a majority of all the votes entitled to be cast"); REVISED MODEL BUSINESS CORPORATION ACT § 14.04 (same for revocation of dissolution proceedings).

319. Many antitakeover statutes empower directors to bypass shareholder input in business combinations, *see supra* notes 108-14 and accompany text, and in control share acquisitions, *see supra* notes 115-25 and accompanying text.

We believe that shareholders should vote to approve these (and similar) fundamental changes because they grant directors dispositive power, in effect, to bypass shareholder input. Currently, antitakeover legislation represents the most pervasive form of antishareholder transfer of power to directors. We suggest that other antishareholder legislation (whether or not associated with takeovers) which discriminates against share acquisitions not accompanied by director approval should similarly require shareholder approval.

320. These would include, for example, amendments which reduce the percentage share purchase necessary to trigger the plan's provisions. *See* Matheson & Olson, *supra* note 6, at 1514 (proposing guidelines for the adoption of shareholder rights plans).

321. *Cf.* Shareholder Bill of Rights, *reprinted in* Machold, *supra* note 317, at 760 (requiring a shareholder vote on decisions which would "[r]esult in the issuance of debt to a degree which would leverage a company and imperil the longterm viability of the corporation").

322. This clause is consistent with current legislation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(a)(5) (1991); REVISED MODEL CORPORATE BUSINESS ACT § 10.04(a), (b) (1984). We would include within the phrase "issuance of securi-

to the voting rights of outstanding shares;[323]

10. Any issuance of securities where the total voting power of the corporation's outstanding securities after the issuance exceeds by twenty percent or more the total voting power of securities outstanding immediately prior to the transaction;[324]
11. Any issuance of a class or series of securities that has separate approval or veto rights with respect to any corporate transaction;[325]
12. Any action of directors which has the foreseeable effect of substantially deterring unsolicited takeover offers, including opting into state antitakeover legislation;[326]
13. Any action of directors which eliminates or limits the rights of shareholders to consider and vote on the election or removal of directors or the timing or duration of directors' terms in office;[327]
14. Approval of compensation agreements (other than routine compensation agreements undertaken in the ordinary course of business) containing provisions, whether or not dependent on the occurrence of any event or contingency, that increase,

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ties" the grant of a right to purchase securities through mechanisms such as options or warrants.

323. For example, granting certain classes of stock super-majority voting power (e.g., two votes per share) would require prior shareholder approval.

324. This requirement parallels current law governing plans of merger which exempt shareholder approval requirements when "the number of voting shares outstanding . . . will not exceed by more than 20% the total number of voting shares with the surviving corporation . . . . " REVISED MODEL BUSINESS CORPORATION ACT § 11.03(g)(3)-(4) (1984).

However, our approach includes *any issuance* of securities in which the total voting power after issuance exceeds the total voting power immediately prior to the transaction by 20% or more. For example, shareholder approval would be required when 20% of the outstanding shares are issued to friendly parties. Under current law, shareholder approval is required only when such 20% outstanding share issuance results in a statutory merger. *See, e.g., id.* The current law thus appears anomalous. Substance should govern over form. Our reform seeks to encompass all of these non-merger 20% issuances of securities.

325. The creation of a class of stock, such as in dual class capitalization contexts, that can prevent transactions which the other shareholders may desire, may act as a significant bar to corporate transactions and may depress shareholder value. Other shareholders should have the right to prevent the creation of such a veto power.

326. This catch-all provision combines ideas from the Proposed Final Draft, *supra* note 14, § 6.02 (action of directors that has the foreseeable effect of blocking unsolicited tender offers) and Matheson & Olson, *supra* note 6, at 1514 (setting out a model act addressing antitakeover issues). This provision seeks to encompass all actions of directors which, in the director's view, have the foreseeable effect of substantially deterring hostile changes in control.

327. *Cf.* Shareholder Bill of Rights, *reprinted in* Machold, *supra* note 317, at 760 (requiring shareholder approval for transactions which would "[a]bridge or limit the rights of the [shareholders] to . . . [c]onsider and vote on the election or removal of directors or the timing or length of their term of office").

directly or indirectly, the current or future compensation of any officer or director of the corporation;[328]

15. Determination of whether to deny a demand to pursue or seek dismissal of a derivative claim against members of the board of directors, officers, employees, or agents of the corporation;[329]
16. Determination of whether to indemnify members of the board of directors, officers, employees, or agents with respect to a derivative action against them.[330]

B. Significant Corporate Matters

Under certain circumstances, acting in an informed manner normally would require meaningful shareholder input.[331] Such input should be sought when it would, in the director's view, materially enhance and inform the director's business judgment, even though not otherwise required by this Chapter. The director's substantial uncertainty about a particular course of conduct on matters implicating shareholders' material longterm financial interests shall require shareholder input. What constitutes meaningful shareholder input depends on the facts and circumstances of each decision, and may even require that shareholder approval be obtained. However, a director's good faith consultation with a Longterm Shareholder Advisory Committee shall be presumed adequate.[332] In certain circumstances, when obtaining shareholder input is functionally or temporally impractical, approval by a majority of the independent[333] members of the board of directors may substitute for such input.

Examples of circumstances where shareholder input normally would be required include but are not limited to:

1. Whether to indemnify members of the board of directors, officers, employees or agents with respect to claims made against them (other than derivative claims) because they occupied those positions;
2. Compensation arrangements with senior executive officers of the corporation, including the right to receive any significant

328. *See* MINN. STAT. § 302A.755 Subd. 3 (1990) (banning "golden parachutes"). We condition the applicability of golden parachute provisions upon prior shareholder approval.

329. As to dismissal with derivative actions generally, see Proposed Final Draft, *supra* note 14, §§ 7.01 to 7.17.

330. For example, Delaware allows indemnity for derivative actions only when the defendant is "successful." *See* DEL. CODE ANN. tit. 8, § 145(b) (1991).

331. As to the requirement of acting in a informed manner generally, see Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (holding that the "concept of gross negligence" is the "proper standard" for determining whether a business judgment is "an informed one").

332. "Longterm Shareholder Advisory Committee" means any committee, comprised of and approved by the shareholders, primarily designed to represent the longterm shareholders' interests for purposes consistent with the requirements of Section 1.02 of this proposal.

333. *See* Proposed Final Draft, *supra* note 14, § 1.15 (defining disinterested directors as those "who are not interested in the transaction") (cross-references omitted).

stock or cash bonus, severance payment, or other extraordinary payment;[334]

3. The selection of independent auditors.[335]

IV. ISSUES IN THE APPLICATION OF THE LONGTERM SHAREHOLDER MODEL

The essence of law is to provide fair and equitable guidelines for the resolution of conflicts between opposing parties. Accordingly, the current corporate legal landscape, which all but forecloses meaningful shareholder input in favor of liberating managerial discretion, deserves careful scrutiny.

A longterm shareholder model flows logically from the dialectical development of corporate law. It synthesizes the economically efficient attributes of both the shareholder primacy norm and the longterm corporate welfare norm.

The longterm shareholder model also flows from the current forces shaping corporate law, the "nexus of contracts" model chief among them. By emphasizing the importance of procedural safeguards in which both shareholders and other stakeholders have a voice, the need for corporate law to impose mandatory, substantive terms is minimized. This enhances the role of contracting and maximizes the possibility that shareholders' and stakeholders' expectations will be preserved.

Finally, the proposed governance framework simplifies and streamlines corporate law. Focusing on procedural issues minimizes the need both to articulate substantive corporate law doctrine and to impose legal sanctions for their breach or disregard. Further, it simultaneously adds vigor to the currently moribund duties of care and loyalty, without imposing potentially inefficient or suboptimal substantive governance rules.

A. The Respective Roles of the Corporate Actors

To better understand the nature of this longterm shareholder model, a glimpse at how it might operate in practice is necessary. Accordingly, this section of the Article discusses the role of the board of directors within the longterm share-

334. *Cf.* Shareholder Bill of Rights, *reprinted in* Machold, *supra* note 317, at 760 (requiring "approval of at least a majority of independent directors . . . to approve [annually] . . . [t]he compensation to be provided to each executive officer of the corporation").

335. *See id.* (requiring "approval of at least a majority of independent directors . . . to approve [annually] . . . the selection of independent auditors").

holder regime, explores the function of longterm shareholders, and analyzes the implementation of the proposal given the facts of a leading corporate law case, *Paramount Communications v. Time, Inc.*[336]

1. The Board's New Role

The longterm shareholder model proposed in this Article envisions a modified role for the board of directors. The board's primary function will be to serve as a central mediator between shareholders and stakeholders.[337] The proposal attempts to reinvigorate the duty of loyalty by requiring boards to consider the interests of longterm shareholders in conjunction with stakeholder interests. Moreover, the proposed framework resurrects the duty of care[338] by requiring directors, under certain circumstances, to seek shareholder input as a minimal procedural safeguard to assure informed decision making. Thus, the board would have an affirmative duty to seek shareholder input in conflict transactions materially affecting shareholders' longterm financial interests. Board proposals which effect a fundamental change in the corporation's governance regime shall require shareholder approval. Any board action approved by shareholders should be conclusively presumed to be in their best interest; the board should be free from liability. For significant corporate matters otherwise materially affecting shareholders' longterm financial interests, shareholder input should be sought. What constitutes meaningful shareholder input is largely within the board's discretion.[339]

336. 571 A.2d 1140 (Del. 1989).

337. Consistent with its view that the board of directors serves as a steward for shareholders' interests while also serving as an interface between shareholders and nonshareholders, the Business Roundtable "recognized that it might be necessary to give shareholders an explicit right to nominate directors." Business Roundtable 1978, *supra* note 219, at 3. Unhappily, in its 1990 Report, the Roundtable abandoned this position in favor of strengthening CEO supremacy. *See* The Business Roundtable, Corporate Governance and American Competitiveness (1990), *reprinted in* 46 BUS. LAW. 241 (1990) [hereinafter Business Roundtable 1990].

338. Given that the duty of care has all but evaporated, the primary function of current corporate law is to minimize the possibility of conflicts of interest between shareholders and nonshareholders. *See supra* part I.D.2. (describing legislation limiting or eliminating the duty of care).

339. Shareholder approval must be meaningful. In order for this to occur, the voting shareholders must have adequate disclosure to make informed decisions. For examples of how a shareholder vote may be problematic under current laws and practice, see Eisenberg, *supra* note 14, at 1474-80. In addition, the balancing of shareholder and stakeholder interests requires directors of

2. The Nature and Role of the "Longterm Shareholder"

When does a shareholder become a "longterm shareholder?" No neat formula exists. In one sense, longterm shareholders are those shareholders who have a significant stake in the future of the corporation. From this perspective, longterm shareholders mirror shareholder/owners of closely held corporations. Since they have a substantial stake in the longterm profitability of a corporation, longterm shareholders seek to maximize the underlying profit-generating engine of the corporation. Their legitimacy derives largely from their possession of a genuine stake in the corporation. Unlike other stakeholders, longterm shareholders are also the owners and ultimate risk-bearers of the corporation. Thus they have additional incentives to hold management accountable.[340]

Thus, the pertinent question is: When does a shareholder of a large publicly held corporation become a bona fide *stakeholder* in the longterm profitability of a corporation? Two possible answers exist. First, a shareholder becomes a longterm shareholder whenever that shareholder's stock ownership is so pervasive that the shareholder can expect to hold stock in the corporation on a continual and recurring basis. Such a situation frequently occurs with large institutional investors. In a sense, these massive institutional shareholders are forced to be longterm shareholders; they do not have the luxury of taking the "Wall Street walk." Their portfolios are so large that it is unreasonable for them to monitor the performance of each corporation. As a result, these shareholders maximize the return on

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the highest caliber. Accordingly, we recommend infusing boards with Gilson and Kraakman's "professional directors." *See* Gilson & Kraakman, *supra* note 12. Furthermore, consistent with the longterm shareholder focus, we recommend that board members strive to become "longterm directors." Perhaps even Martin Lipton would sanction this. *See* Lipton & Rosenblum, *supra* note 12, at 202-03. The result of this is what could be called "longterm professional directors." We leave open the issue of the nature and extent of shareholder involvement in the director nomination process. This should be left to each corporation.

340. One commentator has stated:

> I accept the fact that shareholders with the credibility and avowedly longterm view of . . . [CalPERS] have a place in the corporate governance process. With an enlightened approach . . . both shareholders and corporate executives have more in common than anything that divides them. . . . There is a gap that can only be filled by the owners of the business.

Louis Lowenstein, *Shareholders, Humbug! Giving them Top Dollar Could Cheat Us All*, WASH. POST, Jan. 14, 1990, at B1.

their shares by indexing their portfolios.[341]

At first blush, because they cannot meaningfully monitor all components of their large portfolios, it seems absurd to imagine these indexed investors as "real" shareholders similar to those in closely held corporations. Currently, indexed shareholders do not have the incentive and the ability to monitor managerial performance of all corporations within their portfolios. However, if the corporate law landscape did afford those major shareholders a voice in certain fundamental procedural issues, they would have both the incentive and ability to monitor fundamental governance parameters within *each* of their investments.

This prospect suggests the possibility of a second type of longterm shareholder. Given the proposed procedural governance framework, institutional and other major shareholders may find it profitable to limit their shareholdings to those corporations susceptible to effective monitoring. Thus, they may prefer to monitor portions of their investments directly instead of (or in conjunction with) indexing their funds. A procedural governance framework like the one proposed in this Article could allow such direct monitoring.[342]

3. Longterm Shareholders' *Time* has Come

The celebrated case of *Paramount Communications, Inc. v. Time, Inc.*[343] demonstrates the critical need for a procedural governance framework. The Delaware Supreme Court allowed Time's board to redesign its proposed business combination with Warner, thereby eliminating the need for structured shareholder input. Specifically, Time and Warner originally agreed upon a stock-for-stock merger in which the Time shareholders would receive approximately $125 per share. But when

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341. Roughly "one-third of all equity investments held by institutional funds are 'indexed.'" Coffee, *supra* note 13, at 1339 & n.236.

342. Professor Coffee writes:

> In theory, a diversified portfolio can be assembled with as few as 15 stocks, and 95% of the value of diversification can be achieved with a portfolio of only 20 stocks. Clearly, indexing does not require the purchase of all of the Standard & Poor's 500, and 'excess' diversification is thus wasteful because it raises the transaction costs, both in terms of unnecessary securities transactions and unnecessary monitoring. Although it may be impossible for any investment manager to monitor 500 stocks, even a medium-sized institution could monitor 25 or 50.

Id. at 1355 (footnotes and citations omitted).

343. 571 A.2d 1140 (Del. 1989).

Paramount entered the drama with a cash bid for $175 (later raised to $200 per share), Time and Warner revised their plan, making the transaction a tender offer instead of a merger, thus circumventing shareholder voting requirements and incurring an enormous debt burden of seven to ten billion dollars. Prospective earnings evaporated because roughly nine billion dollars of goodwill had to be paid for and amortized.[344]

Time-Warner shunned shareholder input in favor of: forcing upon shareholders and stakeholders a plan which was at least $50 to $75 per share below the market's evaluation of the stock; restructuring the deal so as to preempt shareholder approval requirements while incurring massive amounts of debt; refusing to meet with Paramount to discuss its offer; and establishing a line of succession for managing and directing the company, thereby bypassing a fundamental function of future boards of directors elected by shareholders.[345]

All of this was legitimized by the Delaware Supreme Court's decision. The *Paramount* case thus suggests that directors may ignore shareholders even if the action is patently self-interested.[346]

This approach runs contrary to this Article's central tenet that as the potential for conflicts of interest increases, so does the need for shareholder input.[347] The proposed governance framework would attempt to foster a fairer and more efficient outcome. Shareholder approval of the revised Time-Warner deal would be required since there was a fundamental restructuring of the governance regime in at least four areas. Specifically, merger negotiations were abandoned; Time-Warner incurred massive amounts of debt; pre-existing shareholder voting rights regarding the succession of managers and directors were preempted; and Time-Warner adopted its poison pill without shareholder approval while ignoring shareholder input in

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344. *See* Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STET. L. REV. 197, 209 (1991).

345. 571 A.2d at 1147-49.

346. The *Paramount* court explained:

> Finally, we note that although Time was required, as a result of Paramount's hostile offer, to incur a heavy debt to finance its acquisition of Warner, that fact alone does not render the board's decision unreasonable so long as the directors could reasonably perceive the debt load not to be so injurious to the corporation as to jeopardize its well being.

Id. at 1155.

347. *See* text accompanying *supra* note 302.

contemplating the desirability of its redemption.[348]

Time's board should have sought the input of its longterm shareholders and longterm stakeholders *ab initio*. Instead, as encouraged by the permissive Delaware legal landscape, shareholder input was actively avoided, almost assuring that the Time board, fraught with self-interest and uncertainty, would reach a sub-optimal conclusion.

B. Benefits of the Longterm Shareholder Model

1. Enhanced Monitoring and Accountability

To the extent that longterm shareholders are granted a greater legal basis to express their sentiments regarding matters in which managements' interests may diverge from other constituencies, management will more likely be accountable to those with vested corporate interests, especially longterm shareholders. Monitoring takes substantial effort. Only those shareholders with incentives to monitor will undertake the task. By focusing upon significant procedural and structural issues common to all corporations, the proposed governance framework harnesses the incentives of longterm shareholders to monitor significant but limited aspects of corporate governance for each of their shareholdings.[349] The result is that corporations will have procedural safeguards to minimize conflict situations while holding management accountable to major longterm shareholders and other longterm stakeholders. Moreover, courts have proven particularly well-suited to assess procedural fairness.[350]

This proposal sets out only the *minimal* procedural safeguards needed to foster accountability. It is a start. If accountability continues to be an issue for any given corporation, longterm shareholders may find it desirable to offer additional procedural safeguards.

2. Enhanced Board Decision Making

By soliciting the input of longterm shareholders (including major stakeholders) in appropriate fundamental transactions, directors should make better-reasoned decisions. Currently, a director seeking to balance the needs of shareholders and non-

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348. 571 A.2d at 1143-49.

349. For a discussion of process and structural issues currently on institutional shareholders' agenda, see Black, *supra* note 8, at 836.

350. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985) (holding the board to a high standard of procedural integrity and fairness).

shareholders faces a quagmire of uncertainty unless she actively seeks shareholder input for fundamental decisions affecting the corporate governance regime. "By failing to encourage shareholder input, the current legal landscape effectively discourages directors from mitigating their uncertainty; it discourages directors from seeking shareholder guidance."[351]

Better decision making also results because the longterm shareholder model offers a single standard: the longterm shareholder standard. Rather than leave directors guessing about what is entailed in a corporate welfare or stakeholder standard, directors need focus only on a discreet constituency.[352]

3. Enhanced Economic Efficiency

To maximize economic efficiency, corporate decisions require an optimal blend of incentives, information, discretion, and oversight. Incentives are the key. Constituencies with adequate incentives will find ways to increase their available information, discretion, and oversight.

Most decisions are best left to managers. For example, only managers have the incentives and information to perform and oversee daily operations. Other stakeholders lack incentives and information to participate meaningfully in this operational domain. What incentives do shareholders have, in their capacity as shareholders, to monitor management and/or provide meaningful guidance to directors? Consider an observation by Easterbrook and Fischel:

> As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions. The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive

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351. Matheson & Olson, *supra* note 6, at 1491.

352. *See* CLARK, *supra* note 6, § 1.2, at 20 (1986). Dean Clark develops an argument in favor of the "social value" of having a single goal, such as profit maximization, for corporations.

> A single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests. . . . Assuming shareholders have some control mechanisms, better monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do and do it efficiently.

Id. (footnote omitted).

> most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion [or ensure that it is exercised on their behalf].[353]

Easterbrook and Fischel further suggest that the shareholders' position within the firm is unique since only shareholders have a meaningful stake in *every* decision made by a corporation.[354]

However, there are two cases when longterm shareholder input is a *sine qua non* for maximizing economic efficiency. First, certain fundamental corporate transactions so affect longterm shareholders' financial interests that only *they* possess the requisite incentives to monitor the integrity of these transactions. In these cases, shareholders can harness the economies of scales in monitoring and providing input.[355] These scale economies allow shareholders to overcome their tendency toward passivity.[356] Further, a shareholder who monitors and provides input on the same type of procedural or structural issue time after time has a heightened incentive and ability to provide meaningful input. As longterm shareholders find that their input actually has an impact upon corporate performance, their incentives to develop more sophisticated skills and means for providing profit-maximizing monitoring and guidance will increase, further strengthening economic performance. Thus, whether an investor *today* has monitoring skills is irrelevant. The issue is whether certain types of shareholders may have incentives to develop into meaningful monitors given a more sympathetic governance regime.

Second, certain transactions are so fraught with conflicts of interest that no one decision maker can make an optimal decision. In these situations the central decision maker should solicit the input from the groups whose interests compete for supremacy. Here a board must balance the input of managers, longterm shareholders, and longterm stakeholders. This balancing of competing interests will more likely lead to an efficient outcome consistent with the longterm objectives and expectations of all corporate stakeholders. Still, the ultimate focus must be on longterm shareholder welfare.

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353. Easterbrook & Fischel, *supra* note 52, at 403.

354. *Id.* at 404.

355. Coffee, *supra* note 13, at 1352 (noting that "because indexed investors hold shares in numerous companies, they seem more able to exploit economies of scale in reaching voting decisions and coordinating to oppose management").

356. *See* Black, *supra* note 13, at 523-24 (noting that the basic tendency for shareholders is to consider their investment as passive).

The focus on longterm shareholders maximizes economic efficiency over time. By harnessing shareholder incentives to monitor and guide directors, systemic improvements in corporate governance will result. These improvements in the way corporate governance powers are allocated guarantee that society as a whole will benefit in the long term.

4. Bridging Ownership and Control

By focusing on shareholder voice rather than shareholder control, ownership and control are bridged rather than united. In order for shareholders to become significant corporate partners, they must have a genuine stake in the underlying profitability of the enterprise. Although such a stake implies a longterm commitment and thus limits unhampered liquidity, some liquidity remains intact.[357]

Moreover, bridging ownership and control implies bridging the conflicts of interests which inhere in the ownership control dichotomy. This minimizes conflicts of interest between shareholders and managers. By soliciting and balancing input from longterm shareholders, the board is well-situated to arrive at a decision which eliminates or minimizes the conflicts between shareholders and nonshareholders.

C. RESPONDING TO POSSIBLE CRITICISM

1. Shareholders Make Poor Monitors

The central scholarly criticism of the model proposed in this Article might proceed as follows: Plagued by agency costs, conflicts of interest, collective action problems, and a maze of regulatory prohibitions, institutional investors lack the capacity and incentive to monitor their shareholdings meaningfully.[358] Some would further argue that even if shareholders *could* effectively monitor their portfolios, they may prefer unhampered liquidity over voice.[359]

We reject the claim that shareholder passivity is inevitable[360] by attempting to redefine the parameters of monitoring.

357. For a thoughtful discussion of this liquidity/control dichotomy, see Coffee, *supra* note 13 (concluding that "those institutions that most desire liquidity would make poor monitors").

358. For scholarship exploring possible barriers to effective shareholder monitoring, see Black, *supra* note 13; Rock, *supra* note 13; *see also* Black, *supra* note 8, at 820-30 (describing the legal obstacles to shareholder action).

359. *See* Coffee, *supra* note 13, at 1287.

360. *See* Black, *supra* note 13, at 525 (similar contention).

First, the definition of what constitutes meaningful shareholder monitoring is explicitly limited to those procedural and structural conflict issues materially affecting longterm shareholders' financial interests. This proposal does not consider the incentives or abilities of shareholders to monitor beyond this limited domain.

Second, by redrafting corporate law, this proposal enhances the incentives and abilities of shareholders to monitor process and structural conflict issues. Some institutional investors will seek to monitor; others may never want to. The outcome depends in part on the cumulative effect of institutional conflict of interests, incentives, and regulatory hurdles, an outcome no one can predict at this time.[361]

Again, the issue is not whether shareholders *today* are poor monitors, but whether they can become effective monitors under a different legal regime. Moreover, those institutional investors who do not choose to monitor can delegate the task to institutional directors, proxy advisors, or other outside monitoring specialists. If monitoring skills become sought-after, institutions will develop them.

2. Managerial Discretion is Compromised

The main argument raised by managers and directors might be that shareholders' ability to "veto" pro-management transactions amounts to shareholders' "management by referendum."[362] This, of course, brings into focus the conflicts of interest stemming from the tension between maximizing managerial discretion versus harnessing shareholders' incentives to monitor that discretion.

The proposed governance framework may actually *increase* risk taking and managerial discretion. By obtaining meaningful shareholder input, directors have done everything necessary to minimize conflicts of interest while maximizing their informed judgment. They have met the burdens imposed by the duties of care and loyalty. Knowing that shareholder approval minimizes their liability, the proposed framework will encourage directors to take risks on the content of items submitted to shareholders for approval.

Finally, the extent of shareholder intrusion into the mana-

361. *See id.* at 608.

362. For an example of this viewpoint, see Business Roundtable 1990, *supra* note 337 (noting that "[e]xcessive corporate governance by referendum in the proxy statement can . . . chill innovation and risk-taking").

gerial domain is limited to significant conflict situations which affect longterm shareholders' financial interests. Operational issues remain within managers' exclusive domain.

CONCLUSION

This Article foretells the significant role of the longterm shareholder in modern corporate governance. Signs of this inevitability abound. Holdings of institutional investors are markedly increasing while the concentration of their holdings intensifies. Major shareholders are developing increasing expertise in longterm corporate matters. Institutional shareholders are becoming increasingly unsettled by the growing tides of anti-shareholderism.

This Article proposes a model for the role of the longterm shareholder and buttresses this theoretical model with a proposed statutory corporate governance framework. The proposal grants major shareholders a meaningful opportunity and mechanism for enhanced participation in formulating longterm corporate affairs. It affords them an unprecedented incentive to invest for the long term, not unlike that of shareholder/managers of closely held corporations.

As a result, ownership and control will be more aligned than under the current system. From a longterm perspective, many of the advantages of entrepreneurialism (marked by the union of ownership and control) and managerialism (marked by the continued high level of discretion granted directors toward harnessing managerial expertise) promise to maximize economic prosperity to society's benefit.

One significant feature of this proposal is that it flows logically from both the nature of corporate governance and the current forces shaping the destiny of corporate law. First, corporate law appears to evolve dialectically. Accordingly, reform proposals ultimately must confront this progression in order to promote the synthesis of shareholder primacy and longterm corporate welfare. Second, reform must harness the incentives of shareholders toward maximizing economic efficiency. To this end, this Article emphasizes the need for a procedural governance framework. Such a "process approach" flows naturally from the very forces which support the "nexus of contracts" interpretation of corporate law.